

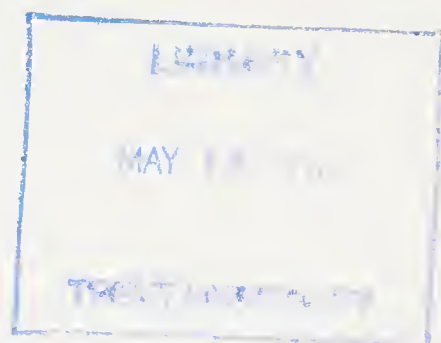
ANNUAL REPORT

FEDERAL RESERVE BANK OF NEW YORK



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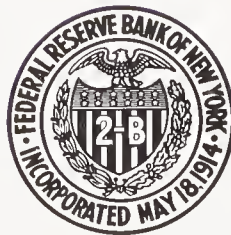
1995



FEDERAL RESERVE BANK OF NEW YORK

Eighty-first Annual Report

FOR THE YEAR ENDED
DECEMBER 31, 1995



SECOND FEDERAL RESERVE DISTRICT

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FEDERAL RESERVE BANK OF NEW YORK



April 1996

To the Depository Institutions in the
Second Federal Reserve District

I am pleased to send you the *Eighty-first Annual Report* of the Federal Reserve Bank of New York, which includes a speech delivered to the Mortgage Bankers Association on January 11, 1996. In the speech, I discuss why price stability is essential for maintaining a stable financial environment and a strong and growing economy. I conclude that the achievement and maintenance of price stability should be the principal long-term goal of monetary policy, and urge businesses and government to address the significant structural problems facing the economy.

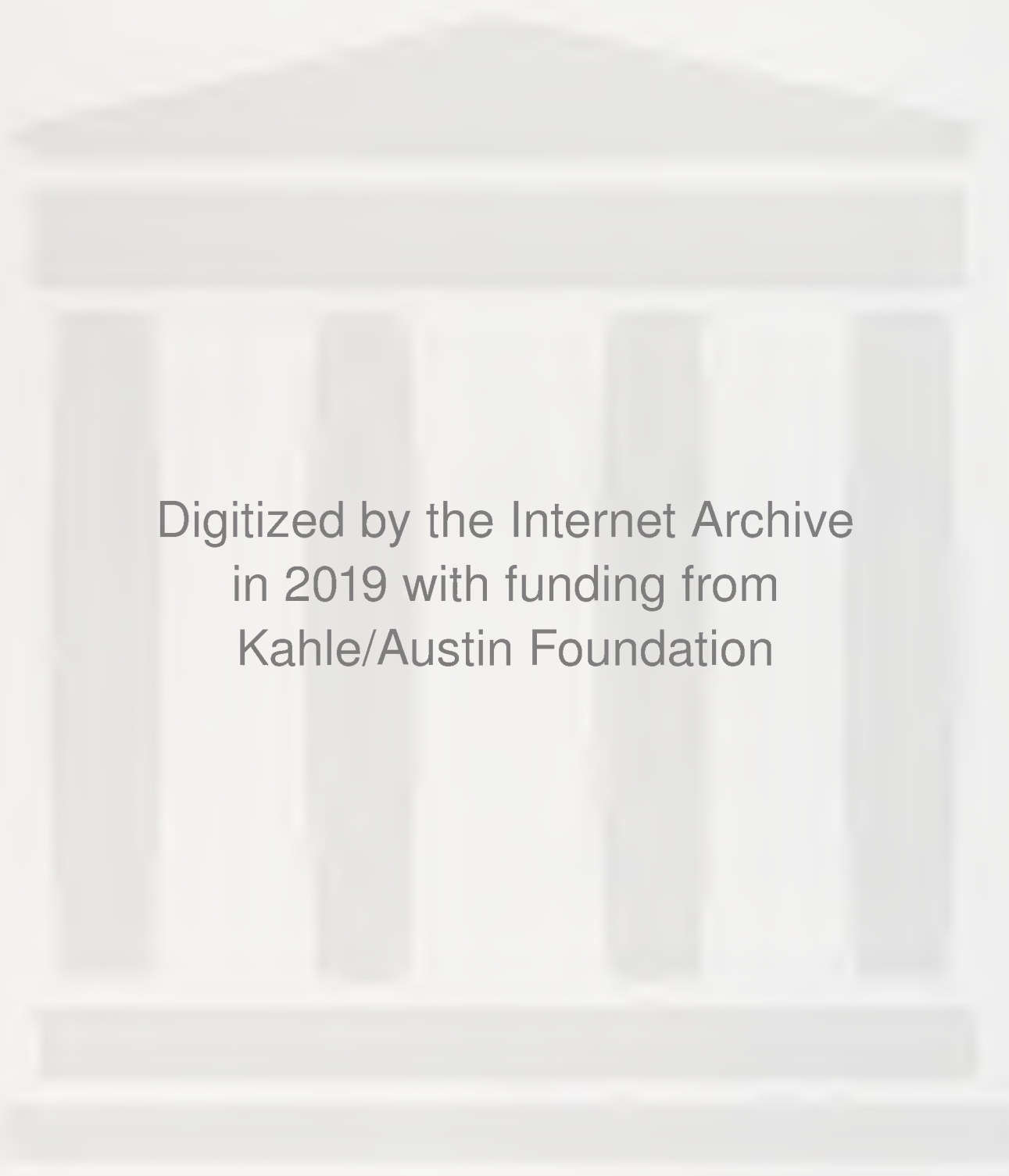
For the first time, the *Annual Report* also includes a Report from the President. Here, I review a number of the Bank's accomplishments in 1995 and identify some major challenges that will face the Bank in 1996 and the years beyond. Additionally, this *Annual Report* presents greater detail on the Bank's financial condition, as represented by the inclusion of notes to the statements.

I hope that you will find this year's *Annual Report* interesting and informative.

William J. McDonough
President

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Speech by
WILLIAM J. McDONOUGH, President
Federal Reserve Bank of New York
before the
Mortgage Bankers Association

New York, New York

January 11, 1996

I am pleased to be here this morning to address the Annual Outlook Conference of the Mortgage Bankers Association. I am delighted that mortgage banking continues to be an innovative and strong industry in the economy. The long-run growth record of your industry is clearly very impressive—the mortgage bankers' share of the primary mortgage market is now around 50 percent, up from below 20 percent in the mid-1970s.

In my remarks this morning, I would like to step back a bit from current developments in the economy and financial markets, and offer a somewhat longer term perspective on the role of monetary policy in achieving and maintaining a noninflationary growth environment. I also will touch on another subject of importance to us all, the economic and financial well-being of weaker segments of our society and the challenges we face in promoting growth and job opportunities in our cities and local communities.

I am quite encouraged by the recent cyclical performance of the economy. Monetary restraint in 1994 brought about a much needed slowing in aggregate demand that had started to run well

Much of our success in containing inflation in recent years reflects monetary policy actions that pre-empted inflationary pressures before they actually showed up in general prices.

ahead of the economy's potential. Such restraint was clearly needed to contain emerging inflationary pressures and to consolidate progress in reducing inflation since the early 1980s. The transition to sustainable growth now seems to have been completed, with only limited potential at present for accelerating inflation. While monetary policy must—and will—continue to be disciplined, the long-sought soft landing appears to have been achieved.

One of the most heartening features of the current expansion is the continuing good news on inflation. In fact, recent inflation rates are the lowest in a generation. Consumer price inflation is now running below 3 percent a year, and with very small increases in labor costs—due both to strong productivity growth and modest growth of compensation—I do not see conditions in place for much deterioration in the near future.

I am convinced that much of our success in containing inflation in recent years reflects monetary policy actions that pre-empted inflationary pressures before they actually showed up in general prices. The pre-emptive policy approach was highlighted in early 1994 when the Fed began firming monetary conditions because of our concerns over inflation re-emerging. While there was no apparent acceleration in actual price inflation at that time, the buildup of underlying inflationary pressures was evident in various forward looking indicators and forecasts of the economy.

The main reason we need a pre-emptive approach is that monetary policy works with uncertain and long time lags. Estimates of these lags vary widely, but most of the effect of monetary policy on economic activity seems to take place within one to two years, and its impact on inflation usually takes longer. Thus, I think the appropriate horizon for Federal Reserve policymakers is one to three years.

The inflation experience of the last two decades has strengthened the case for a pre-emptive approach to monetary policy. Specifically, that experience indicates that an overheating economy has a much stronger effect in raising inflation than subpar growth has in lowering inflation. This asymmetry reinforces the need for pre-emptive monetary policy actions because failure to contain inflationary pressures at an early stage makes it much tougher to deal with inflation at a subsequent stage.

The historical inflation experience also has built up broad professional and public support for the need to achieve and maintain low inflation or price stability. Most elected officials, economists, and the general public have become much more aware that the economic and social costs of even moderate rates of inflation are pretty substantial. These costs result from a variety of sources: deleterious effects of uncertain future prices on long-run business decisions and economic growth; problems caused by inflation for nominal contracts; distortions associated with the interaction between inflation and the tax system; and, more generally, the reduced effectiveness of the price and market systems.

While it is difficult to quantify the adverse effects of inflation on the economy, empirical analysis suggests that such effects can be quite significant. For example, estimates of the costs of a persistent 10 percent inflation are from 2 to 5 percent of GDP. In today's prices, this amounts to a range of about \$150 billion to \$350 billion for the U.S. economy—a sizeable cost even for the largest economy in the world.

If anything, such quantifications understate the overall costs of inflation since they cannot capture various broader, noneconomic aspects of the inflation problem. For example, by depreciating the value of the dollar over time, inflation makes our currency less reliable as a standard for measurement of real values of goods, services, and assets in the United States and around the world.

I also believe that inflation has a serious social cost because it falls particularly hard on the less fortunate in our society, the last to get employment and the first to lose it. Such people do not have the economic clout to keep their income streams steady, or even buy necessities, when a bout of inflation leads to a boom-bust scenario for the economy. As a consequence, they suffer disproportionately when the bust comes.

Heightened awareness of the costs of inflation has increased the intensity with which inflation is disliked not just by economists and policymakers, but also by participants on Wall Street and

The primary long-term goal of monetary policy should be price stability, which is best defined as a situation in which inflation is not a consideration in household and business decisions.

the general public on Main Street. Today, one almost never hears the arguments that were so commonplace in the 1960s and the 1970s, about low or moderate rates of inflation being needed to grease the wheels of commerce and industry. Indeed, such views are rejected by recent empirical investigations.

Against the background of generally low inflation and broad public support for policies that rigorously contain inflation, the recurring congressional debate on the appropriate objectives of monetary policy has experienced a recent revival.

Senator Mack has introduced a bill to make price stability the primary long-term goal of monetary policy and Congress is likely to hold hearings on this issue in coming months.

There is no question in my mind that the primary long-term goal of monetary policy should be price stability which is best defined as a situation in which inflation is not a consideration in household and business decisions. For me personally, the goal of stable prices has been the prism for making monetary policy choices. Moreover, for some time now monetary policy has consistently pursued that goal, which is a key factor in the long-run downward track that inflation has been on since the early 1980s.

Nevertheless, a legislative mandate in favor of long-term price stability would help clarify the priorities for policy goals and strengthen our commitment to price stability. By providing a long-term anchor for monetary policy, an explicit commitment to price stability also would help improve the credibility of policy, as well as the Fed's accountability.

With or without a formal legislative commitment, I am convinced that monetary policy must continue to aim at fostering sustainable economic growth, with inflation trending lower and, eventually, giving way to price stability. While recent price performance has brought us pretty close to functional price stability, I think we are not quite there yet. Inflation, as measured by standard price indexes, is now the lowest since the late 1960s, but people still worry about its consequences and about future uncertainty of prices. And these concerns influence their day-to-day spending, saving and investment decisions.

I want to stress that price stability is not a one-time objective, but an ongoing goal. Judging from the significant remaining inflation premiums embodied in long-term interest rates and from surveys of inflation expectations, the job is not yet complete. But even as we succeed in achieving true price stability, there will be no room to relax our guard. Past successes will not be worth anything if we become complacent about future inflation.

Many analysts seem to think that establishing price stability as the primary goal of monetary policy means that the Federal Reserve would no longer be concerned about output or job growth, or that it would have no responsibility for coping with cyclical weakness of the economy. I believe that view to be simply wrong. Instead, a clear official mandate for price stability will allow the Fed more explicitly to address cyclical problems.

In my view, a stable economic and financial environment will almost certainly enhance the capacity of monetary policy to fight occasions of cyclical weakness in the economy. With no significant

There is no conflict between real growth and price stability, and the assumption that efforts to contain inflationary pressures will depress economic growth is clearly not borne out by historical experience.

inflation premiums in long rates and the public's hostile attitude toward inflation, monetary policy would be able to ease in the short run without risking an immediate surge in inflationary expectations. Indeed, there was considerable room for monetary policymakers to do just that in the low inflation environment of the 1950s and the early 1960s.

All too often, commentators argue as if Federal Reserve policy aimed at containing inflationary pressures is tantamount to pursuing real growth targets limited to 2 - 2 1/2 percent. The Fed, of course, has no such targets, and does not believe that looking at actual or prospective real growth, by itself, tells you much about the underlying inflationary pressures.

In trying to determine the extent of future inflation, we must look at a variety of indicators of demand pressures and supply developments in the economy. As you know, the list of these indicators is long and includes such things as measures of the degree of tightness in labor markets, industrial capacity utilization rates, estimates of the gap between actual and potential GDP, developments in commodity prices and monetary aggregates, the extent of foreign competition, and the behavior of the yield curve. While some indicators have proven more useful than others, there is no straightforward summary measure that provides a reliable overall assessment of the many complex and diverse influences on inflation.

More fundamentally, I believe, there is no conflict between real growth and price stability, and the assumption that efforts to contain inflationary pressures will depress economic growth is clearly not borne out by historical experience. In the very short run, say within a year, expansionary

Recent empirical work not only finds a durable relationship between lower inflation and higher levels of GDP and productivity, but also suggests that lower rates of inflation are closely associated with faster growth rates of GDP and productivity.

monetary policy may stimulate the economy. But economists, in an amazing degree of accord in a profession which thrives on controversy, agree that higher inflation does not boost output and employment on a sustainable basis. Any temporary rise in output and employment is more than fully offset as inflation is brought back under control.

From a longer term perspective, the economy's performance depends on a variety of technological, economic, and social factors, and within that context, price and financial stability is a key ingredient for enhancing economic growth. In fact, there is now mounting evidence that lower inflation leads to higher long-run growth. Recent empirical work not only finds a durable relationship between lower inflation and higher levels of GDP and productivity, but also suggests that lower rates of inflation are closely associated with faster growth rates of GDP and productivity. In particular, the postwar history of the United States indicates a strong and statistically robust negative correlation between inflation and real GDP growth, as well as between inflation and productivity growth.

The statistical evidence has not yet established that the negative correlation represents a causal relationship running from inflation to GDP or productivity growth. But such a causal link is entirely consistent with the various costs of inflation. In any event, I am persuaded by common

sense and casual empiricism that lower inflation almost certainly benefits long-run growth, even if it is not possible to pin down the size of the effect involved.

One of the main linkages between price changes and the economy is that low inflation feeds lower interest rates and lower capital costs, and thereby spurs long-run productivity and economic growth. Lower interest rates result not only from reducing or eliminating inflationary expectations, but also from increased efficiency of capital markets.

I certainly don't need to tell this audience that the housing market is one of the most important channels through which lower interest rates influence the economy. Housing affordability, a key to broadening economic opportunity, is closely connected to long-term interest rates since the qualifying income to buy a house is determined by long rates. By lowering mortgage rates, the decline in the trend rate of inflation has greatly enhanced housing affordability over the last ten years or so. For example, with the thirty-year mortgage rate dropping from 12 1/2 percent in 1985 to 7 1/4 percent at present, the qualifying income for a \$100,000 home mortgage has fallen from about \$46,000 in 1985 to about \$29,000 today. As a consequence, about twelve million additional households now meet the income standard that was beyond their reach in 1985.

Whatever the precise effects of lower inflation on economic growth, I think there is broad agreement that price stability is essential for maintaining a stable financial environment and for the successful long-run economic performance of the economy. Only with long-run price stability can the economy expect to achieve the highest possible levels of productivity, real income, employment, and living standards.

The process through which price stability enables the economy to deliver the highest sustainable levels of jobs and economic performance is complex and involves all facets of society. Price stability reduces uncertainty and gives people confidence in the future. It allows economic resources to be allocated more efficiently on their real merits, rather than on their advantages as inflation or speculative hedges. It induces households to save more because they don't have to worry about inflation eating up their savings. By reducing uncertainty about future returns and by eliminating inflation premiums in long rates, price stability also encourages businesses to invest in long-term, growth-oriented projects.

As critical as monetary policy is for containing inflationary expectations and for stabilizing the price level, it cannot ensure, by itself, a stable economic and financial environment, and maximum sustainable long-run economic growth. For that, we must also do something about the significant structural problems facing the economy. In particular, as a nation, we continue to con-

sume far too much and save too little to sustain a healthy economy over the long run. About the only effective way to increase national saving is to reduce the federal deficit, which is a major drain on private savings.

I remain hopeful that Congress and the President will agree on a program to put the deficit on a downward path. This action is indispensable for the long-run health of our economy.

In addressing our structural problems and the effectiveness of various social spending programs, we face some very difficult choices. The context of these choices brings me to my next topic, the growing disparity between the haves and the have-nots. I fully share the view that the overall

Exposing individuals least able to compete to the winds of the markets raises serious social and fairness concerns.

economy works best with minimal government interference and that social programs which don't work clearly need to be fixed. But fixing the programs should not mean ending them, because the unsatisfied real needs of many people in our country are, sadly, growing. Exposing individuals least able to compete to the winds of the markets raises serious social and fairness concerns.

We must be particularly careful not to shortchange investment in human capital, especially in the form of education and training. Such an approach will deepen the ongoing trend toward disparity between the haves and have-nots. Over the last twenty years or so, gains from advances in growth and prosperity have not been widely shared, and the less educated and poor segments in our society have actually lost ground. Since 1973, for example, real incomes for households in the bottom fifth of the population have fallen about 15 percent, while those in the top fifth have enjoyed real income gains of 25 percent.

Because of their negative effects on political and social cohesion, the widening disparities clearly are not conducive to strong economic performance of the economy. In the long run, I am convinced, economic growth can be sustained only if the growing economic pie is shared by all parts of society—rich and poor, urban and rural, skilled and less skilled—people of all hues and all backgrounds. Only under those conditions will each of the varied parts of our society have a stake in its future economic development.

While the role of the public sector in creating jobs and economic opportunity is important, government action alone is not sufficient. Private sector participants need to redouble their efforts to

bring job growth and economic prosperity to all levels of our society. This is a task the government simply cannot and should not shoulder alone.

Private sector involvement is important for reasons of raw self-interest. A recent report of the Committee for Economic Development makes a persuasive case along these lines. It makes abundantly clear why each of us—particularly those who are business leaders—has a stake in the inner cities. I share many of the views expressed in the CED report and commend it to you along with its recommendations for greater involvement between businesses and community groups for rebuilding areas where economic blight is most concentrated.

I know that you, as mortgage bankers, have particularly strong interests in community development and progress. I also know that many of you are involved, as we are at the Federal Reserve Bank of New York, in a wide range of educational and community development initiatives, and that banks have accomplished a great deal in activities encouraged by the Community Reinvestment Act. I am sure, too, that many in this audience generously support development efforts through philanthropic and civic organizations.

Indeed, many successes have emerged from partnerships between businesses and community groups around the nation. And there is a broad range of programs and initiatives that the private sector might undertake which can make a critical difference in a number of areas. It can, for example, provide part of the financing required for community development, and I believe that

Private sector businesses . . . can help established community groups to leverage the necessary resources—both financial and nonfinancial—to initiate specific development projects as well as comprehensive community-building strategies.

financial institutions in particular can and should play a greater role in this area. Communities need access to capital to improve their infrastructure, create housing, and attract the businesses that create jobs.

Private sector businesses, through their active involvement, can help established community groups to leverage the necessary resources—both financial and nonfinancial—to initiate specific development projects as well as comprehensive community-building strategies. The private sector can also provide technical assistance to community-based organizations on financial analysis, strategic planning, computer system design and other needs. Similarly, it can play an important role in training our future work force by getting involved with the retraining of workers and our public schools.

It is not my objective to offer a comprehensive agenda for your community involvements, and many of you already are engaged individually and through your institutions in these efforts. My concern is that we not be complacent about the challenge of sustaining our communities and neighborhoods—a challenge that has never been more important than it is today.

I encourage you to expand the role you and your institutions play in addressing the growing needs of inner cities and other poor communities. Only by working together to enhance economic opportunity for weaker segments of our society can we ensure sustained economic development of the whole society and our own quality of life.

Thank you.

OPEN MARKET OPERATIONS
DURING 1995

OPEN MARKET OPERATIONS DURING 1995

INTRODUCTION

During 1995, the Trading Desk at the Federal Reserve Bank of New York managed reserve conditions with the objective of maintaining the federal funds rate around the level desired by the Federal Open Market Committee. The need for permanent reserve additions was much lower than in the preceding few years, mostly reflecting an unanticipated sharp slowing in currency growth and a reduction in reserve requirements caused by the spread of sweep programs at commercial banks. Temporary operations that are used to meet modest or short-lived swings in reserve supply and demand remained heavily skewed towards adding reserves between outright operations.

THE MONETARY POLICY AND ECONOMIC BACKDROP

Monetary policy during 1995 was formulated against a background of modest price pressures and declining inflation expectations and a slowing in the rate of economic expansion from the rapid pace of the preceding year. At the start of the year, inflation remained subdued, but measured utilization rates stood at levels associated historically with intensifying price and wage pressures. Amid signs that economic activity was continuing to advance at a substantial pace, the Federal Open Market Committee (FOMC) took action at its February meeting to raise the federal funds rate by one-half of a percentage point to about 6 percent, matching the size of the increase in the discount rate approved by the Board of Governors that same day. These policy actions proved to be the last in the sequence of restraining moves begun one year earlier (Table 1).

Adapted from a report to the Federal Open Market Committee by Peter R. Fisher, Executive Vice President of the Bank and Manager of the System Open Market Account. Spence Hilton, Markets Officer, was primarily responsible for the preparation of this report. Other members of the Markets Group assisting in the preparation were John Partlan, Gerald Cohen, Eileen Spinner, Joanna Barnish, Theodore Tuplan, Robert Van Wicklen, and Joel Kent.

By midyear, the pace of economic expansion had slowed substantially. Inflationary pressures had diminished, partly as a result of the move to policy restraint begun in 1994, and the FOMC reduced the funds rate by one-quarter percentage point at its July meeting. Over the balance of the year, price performance was somewhat more favorable than anticipated, inflation expectations receded, and the Committee agreed on a further one-quarter percentage point reduction in the funds rate at its December meeting.

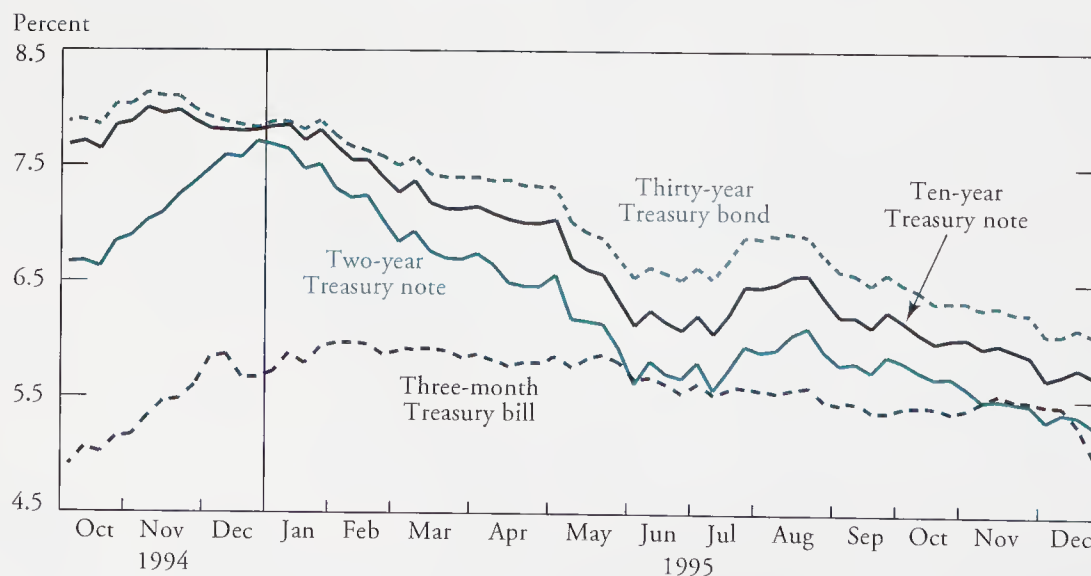
The favorable inflation outlook and moderation in economic activity produced a steady decline in market interest rates that was only briefly interrupted in the summer (Chart 1). Prospects for meaningful progress in reducing federal budget deficits in future years added momentum to the downward trend in rates. Yields on Treasury coupon securities declined by 200 to 250 basis points on balance over the year. Short-term Treasury bill rates posted more modest declines, but at the end of the year shorter term yields stood at levels that reflected widespread market expectations of further policy moves in the months beyond.

IMPLEMENTATION OF POLICY

RESERVE MANAGEMENT PROCEDURES

In carrying out the FOMC's policy directives, the Desk seeks to maintain the federal funds rate around the level indicated by the Committee. Keeping the funds rate close to a desired level entails using open market operations to adjust the System's portfolio of domestic securities to ensure that the total reserve liabilities of the Federal Reserve are in line with the reserve demands of depository

Chart 1
YIELDS ON TREASURY SECURITIES



Notes: All rates are averages for weeks ending Wednesdays. Treasury bill rates are discount rates; note and bond yields are constant maturity yields.

institutions. Over time, most of the permanent expansion in the System's securities holdings has supported growth in currency and higher demand for reserve balances stemming from rising reserve requirements. Temporary open market operations are used extensively to meet residual needs arising from short-lived swings in reserve supply or demand that can pressure the federal funds rate but which are also subject to considerable forecast uncertainty.

Through its operations, the Desk endeavors to provide in each maintenance period a supply of reserves that enables all banks to meet their two-week reserve requirements and that is sufficient to meet daily demands. As a first step, an objective or "path" for nonborrowed reserves is developed for each period. The path is a projection of the reserves depository institutions must hold to meet their reserve requirements plus any desired excess holdings for the period, less an amount of reserves that the Desk anticipates will be created by borrowing at the discount window. The overall volume of reserve operations needed in a maintenance period to keep the funds rate close to its desired level is estimated by comparing the path with projections of the supply of nonborrowed reserves forthcoming from market factors over the same two-week period.

Borrowing at the discount window under the adjustment credit program once had been closely associated with the spread between the level of the federal funds rate sought by the Committee and the discount rate. In recent years, there has not been a systematic relationship between adjustment borrowing and this spread, and typical levels of adjustment borrowing have been negligible. With borrowing now ordinarily expected to make up just a small fraction of total reserve supplies, the Desk must ensure that almost all reserve demands can be met with nonborrowed reserves.¹ Nonetheless, the discount window remains a critical source of supply when nonborrowed reserves are scarce. A bank may turn to the discount window on a settlement day when it cannot secure alternative funding to meet its requirements or at other times to avoid an end-of-day overdraft on its Fed balance, although the discount window is usually tapped only after the funds rate has been bid up to high levels (Chart 2).

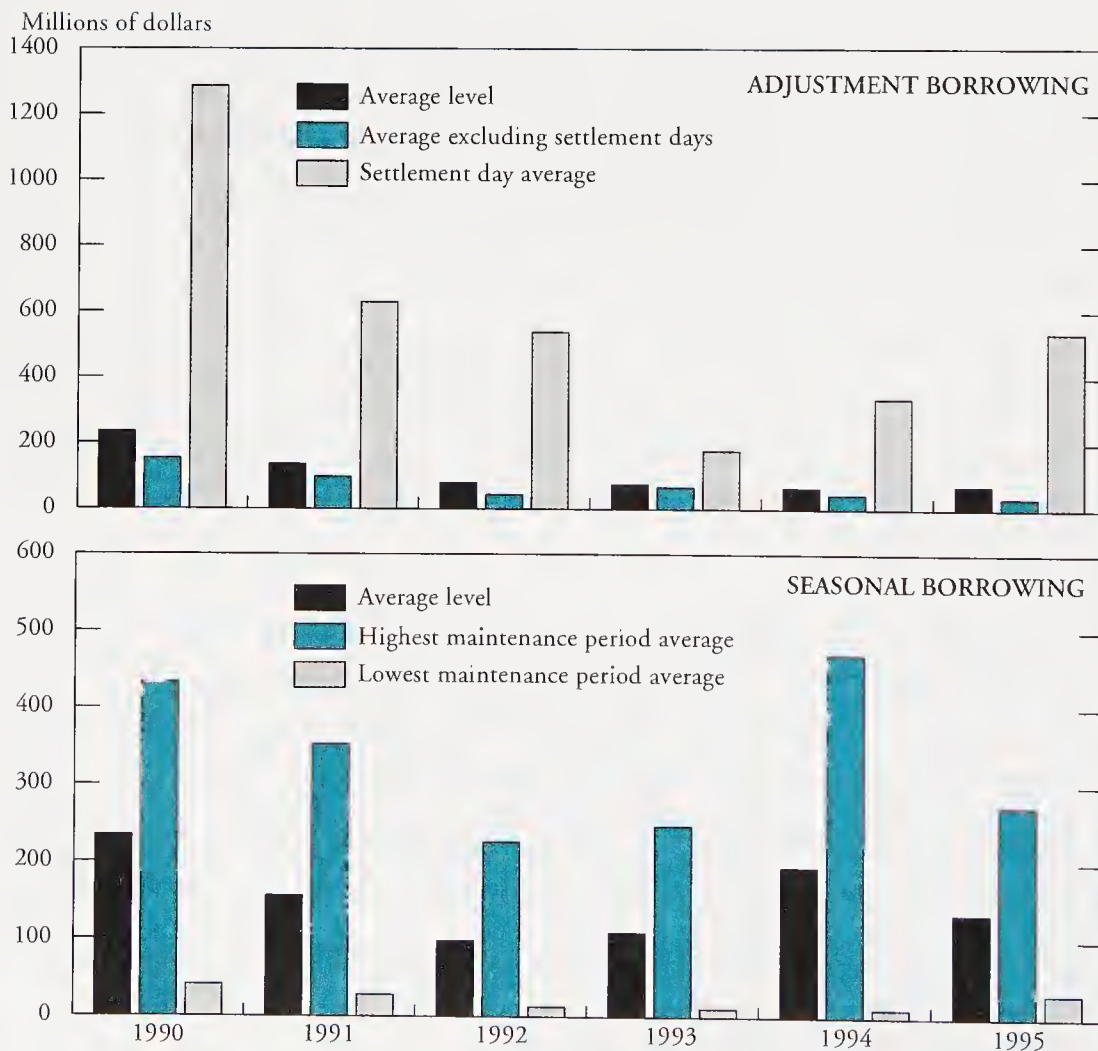
Estimates of the daily pattern of nonborrowed reserve supply and demand guide the selection of specific open market operations within a period. To a large degree, reserve operations smooth daily deficiencies or surpluses—measured as the difference between the estimated level of nonborrowed reserves available each day and the two-week average demand-driven objective in place for the period—although demand for reserves may be very unevenly distributed throughout a period, so the supply of nonborrowed reserves that keeps the funds market trading close to the desired rate may vary over the period.

The Desk's knowledge of operating factors affecting reserve supply, required reserves and both the level and pattern of desired reserve holdings over a period is necessarily imperfect, and such estimates are subject to substantial revision. When daily reserve supplies are estimated to be in line with the path but the funds rate nonetheless deviates from the desired level, the divergence may be signaling an unrecognized shortage or surplus. On the other hand, deviations in the funds rate may reflect misperceptions among bank treasurers and federal funds traders about the true availability of aggregate supplies. At other times, reserve balances can be distributed in a way that does not allow funding markets to pair surplus and deficient banks efficiently.

Small deviations in the funds rate from the expected level often dissipate quickly and may require no response. Large or persistent deviations may be taken into account in the formulation of reserve

Chart 2

ADJUSTMENT AND SEASONAL BORROWING



Note: Each calendar year includes all maintenance periods with its settlement day in that year.

operations because they might reflect needs or preferences of banks that are not captured in the reserve data available to the Desk.

OPEN MARKET OPERATIONS DURING 1995

Reserve Patterns and Outright Open Market Operations

Over time, most of the permanent expansion of the System's portfolio of domestic securities achieved through outright operations has supported growth of currency and of reserves needed to meet the requirements of depository institutions, both of which are Federal Reserve liabilities. In 1995, net changes in currency and reserve requirements necessitated a much smaller increase in the portfolio than occurred in recent years. Measured from year-end to year-end, currency in circulation increased \$20 billion in 1995, compared with a record \$37 billion the previous year and similar increases in 1992 and 1993 (Table 2). Much of the slowing in currency growth was attributable to reduced foreign demand, stemming in part from increased economic stability in several foreign countries.

At the same time, demand for reserves to meet reserve requirements fell for a second consecutive year. Required reserves fell \$3 billion in 1995, after dropping by almost \$2 billion in 1994, as banks implemented sweep programs. Partly offsetting the impact on total reserve demand, many of the banks that implemented these sweep programs raised their clearing balances by \$1 billion.

The behavior of other reserve factors on balance had a small impact on the need for outright transactions. As part of a broad support package for Mexico, \$2.5 billion of Special Drawing Rights held by the Exchange Stabilization Fund was monetized. But the level of matched-sales purchase transactions undertaken with other central banks (the foreign RP "pool") rose by \$4.5 billion over the year and was expected to remain at a high level for an extended period.²

Over the year, \$4 billion of maturing securities were redeemed, which contributed to reserve shortages. Many of these redemptions consisted of maturing original issue seven-year Treasury notes, a discontinued maturity. The Desk also redeemed \$900 million of maturing holdings in October at a 3-month bill auction in light of the Treasury's sharp cutback in the size of the auction that was made in order to remain under its debt ceiling. Federal agency securities were redeemed when there was no suitable replacement offering, and holdings of agency securities fell by about \$1 billion to a level of \$2.5 billion, the fifteenth consecutive yearly decline.

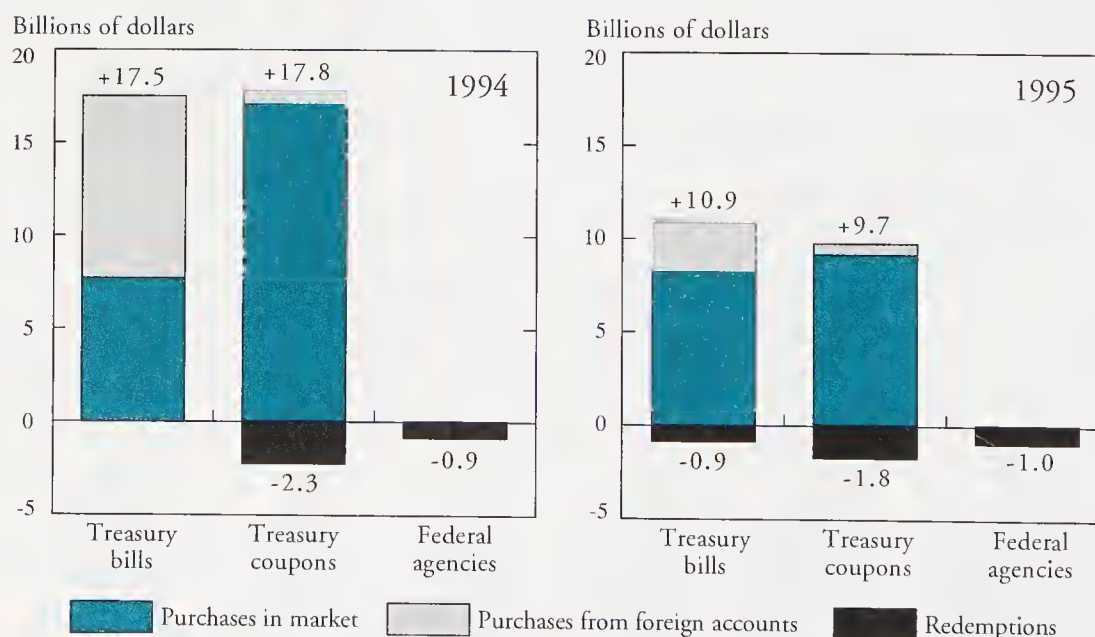
Primarily reflecting the slower growth of currency and drop in required reserves, the total par value of the Desk's outright purchases fell to about \$20 billion in 1995 from \$35 billion in 1994 (Chart 3). Most of these purchases were arranged when large and sustained reserve shortages were

projected to develop. The Desk entered the market on four occasions, down from six market entries the previous year.³ Purchases from foreign accounts were also cut back sharply.

As in each of the two preceding years, there were no outright sales of any Treasury or agency issues in 1995. On balance, the overall portfolio grew a net \$17 billion, far below the \$32 billion addition of the preceding year and the smallest rise since 1990, bringing the total par value of the System's holdings at the end of 1995 to \$393 billion (Chart 4). These various outright transactions and the Desk's auction rollover actions lengthened the average maturity of the System portfolio of Treasury securities slightly, by one month, to approximately thirty-nine months.

Near the end of the year, the Desk adopted a new method for purchasing Treasury coupon securities in the secondary market in order to speed up the processing time of each market entry. In the past, the Desk would solicit propositions on all outstanding Treasury coupon securities in a single operation. With just over 200 issues outstanding and a sizable range of prices often offered for each issue, the turnaround time for evaluating the propositions was typically almost one hour. During this interval, primary dealers were exposed to price movements on the securities they submitted. Under the new framework, instead of a single large transaction, total purchases are divided into separate tranches by maturity, and a smaller operation in each sector is arranged on consecutive business days. The new procedure cuts down the time needed to process the operation and,

Chart 3
SYSTEM OUTRIGHT OPERATIONS



Notes: Purchases are positive values; redemptions are negative values. There were no outright sales of securities in 1995 or 1994.

therefore, the level of risk to primary dealers. The Desk has also found that the shorter turnaround time makes it easier to arrange these operations in the morning without interfering with its temporary transactions. The first of these newer operations was undertaken on November 30, and the fourth and final part was executed on December 6. The turnaround time for each leg of the operation was reduced to ten to twenty minutes.

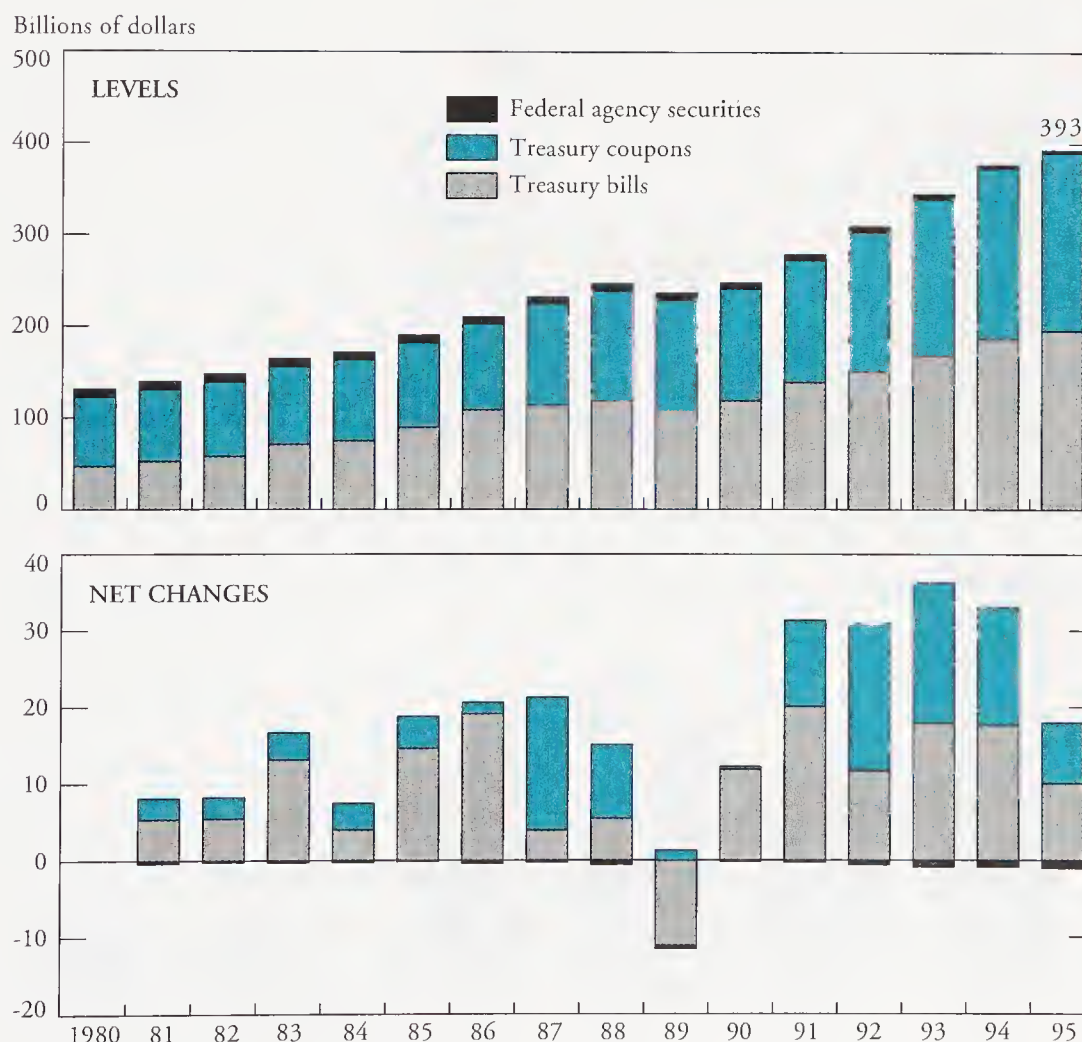
Temporary Operations

Temporary, or self-reversing, operations are used to meet imbalances between reserve supply and demand that are not expected to persist or that are relatively small but which nonetheless would place pressure on the federal funds rate. Most of these operations are used to add small to moderate amounts of reserves because the Desk's outright operations are usually structured to leave

Chart 4

SYSTEM PORTFOLIO OF TREASURY AND FEDERAL AGENCY SECURITIES

Year-end Holdings

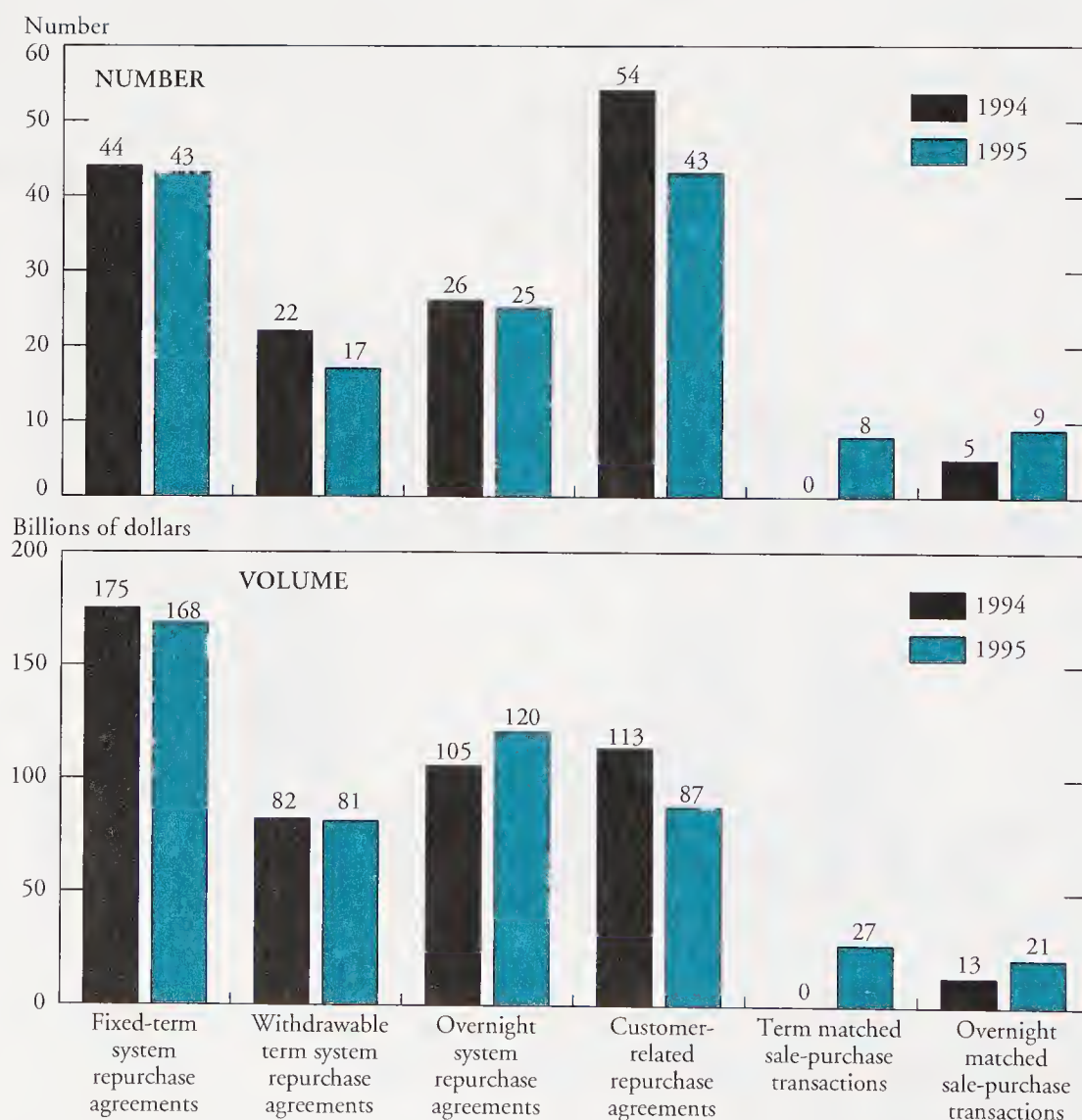


reserve shortages of limited size in most maintenance periods. Large temporary reserve additions or draining operations may occasionally be needed to meet seasonal swings in some operating factors and in reserve demands.

In number and type, the temporary operations selected in 1995 were fairly similar to the previous year (Chart 5). The Desk did drain reserves more frequently than in preceding years, largely because the seasonal reserve surpluses that often emerge early each year were more substantial in 1995 than in recent previous years. The frequency of customer-related repurchase agreements (RP) fell quite a bit.

In a typical maintenance period characterized by a moderate-sized reserve shortage, the Desk often arranged successive multiday, nonwithdrawable operations up through the second weekend. These

Chart 5
SYSTEM TEMPORARY TRANSACTIONS



operations were frequently supplemented by shorter term operations if circumstances warranted. After the second weekend, withdrawable multiday System RPs or overnight operations were employed more often in order to respond to revisions in estimates of reserve supply or demand during the brief time that remained in the period.⁴ When substantial reserve needs were projected in a maintenance period, overlapping term operations were sometimes used. In one such instance, on December 21, a fourteen-day System RP was arranged, a maturity last used in 1978. This operation spanned the entire maintenance period including the year-end date when substantial reserve pressures often arise and was supplemented by several other operations.

In structuring temporary operations, the Desk took account of the intraperiod pattern of demand for reserves, which was often revealed by the behavior of the funds rate. Banks continued to prefer holding somewhat more reserves in the second half of a maintenance period than in the first half, a pattern that became more widespread in 1991 as banks adjusted to working with low required operating balances following cuts in reserve requirements (Table 3). All depository institutions, and in particular large ones, accumulated an especially sizable amount of excess reserves on the last day of the period.

SWEEP ACCOUNTS AND REQUIRED OPERATING BALANCES

During 1995, depository institutions' use of sweep programs for retail customers expanded dramatically. In such programs, funds from reservable household checking deposits are temporarily placed in nonreservable money market deposit accounts. In addition to distorting the relationship between the M1 and M2 aggregates, sweeps reduce total required reserves within the banking system. A critical issue going forward is whether required reserves may fall to levels that will complicate reserve management and increase the volatility of the federal funds rate. Although the current round of sweeps began in January 1994, activity remained moderate for much of that year and into the first half of 1995.⁵ In the later part of 1995, however, the popularity of these programs soared. The cumulative amount of sweeps through June was \$22 billion and climbed to \$54 billion by the end of the year.⁶ The net monthly increase in December was \$9 billion, the largest of the year.

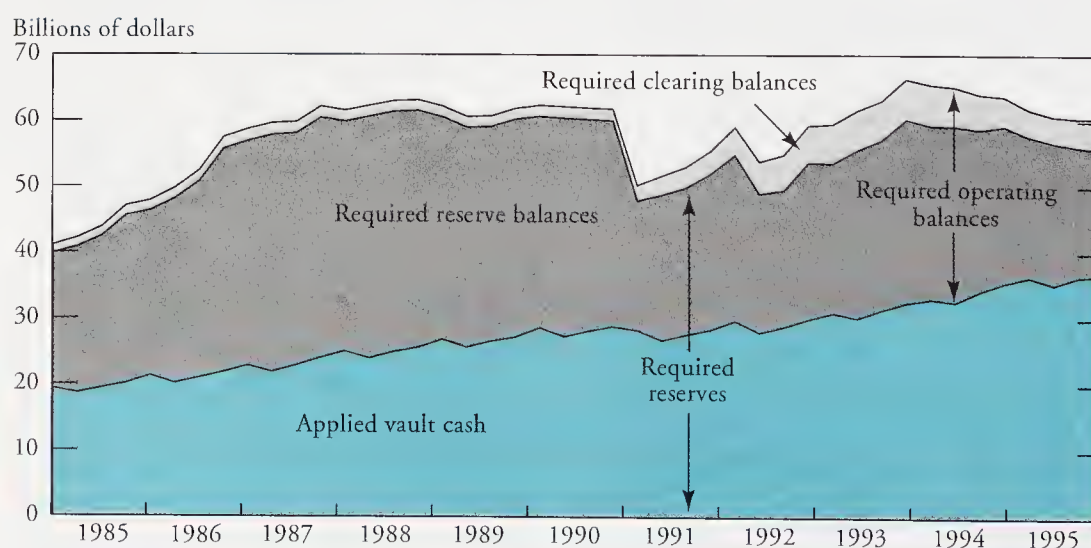
Assuming a roughly 10 percent average reserve requirement, the \$45 billion of cumulative sweeps implemented during 1995 translated into \$4.5 billion fewer reserve requirements for the total banking system. This drop more than accounts for the total decline in required reserves over 1995. At the end of 1995 the level of required reserve balances, which are the balances banks must hold at the Federal Reserve in order to meet reserve requirements not satisfied by vault cash, was \$4.1 billion below its level one year earlier (Chart 6). To avoid serious reserve management

problems, a number of the banks that activated sweep accounts boosted required clearing balances, so that the fall in required operating balances, which includes these clearing balances, was somewhat smaller.

The popularity of sweep accounts may increase the number of days when operating balances are not sufficient to support ordinary clearing needs of depository institutions. Without any Desk action, the likely result would be an increased incidence of firm money market pressures of the kind that arise currently when payment flows in the banking system are particularly heavy. But even when reserve balances at the Fed are adequate for meeting the clearing demands of banks, a low level of required operating balances can complicate the task of a bank reserve manager. Everyday uncertainties are more likely to bring a bank's reserve position closer to the two extremes of either ending overdrawn or holding an excess position that is difficult to work off on subsequent days because required operating balances are low. The Desk can also have more difficulty predicting the level of reserve balances banks would prefer to hold each day. In this environment, the federal funds rate can become more volatile.

When reserve requirements were first cut sharply in 1991, the sometimes extreme volatility in the federal funds rate that immediately followed was seen partly as a byproduct of banks adapting to low required operating balances. The decline in reserve requirements in 1995 brought on by increased sweep activity has not led to a replay of this extreme volatility. As noted before, many institutions implementing sweeps have partly compensated by increasing their required clearing

Chart 6
RESERVE MEASURES



Notes: All figures are quarterly averages. Reserve requirements are the sum of required reserve balances and applied vault cash. Required operating balances are the sum of required reserve balances and required clearing balances.

balances, possibly helping to curb an increase in volatility. Nonetheless, the level of required operating balances continues to trend downward. Whether these declines eventually cause severe reserve management difficulties remains to be seen.

What Is a Sweep?

Simply stated, a sweep occurs when funds are automatically shifted from one account to another. Many sweeps have recently been implemented by large commercial banks for their consumer accounts. Transfers are usually made from a reservable checking account, such as a Negotiable Order of Withdrawal (NOW) account to a non-reservable money market deposit account (MMDA). The bank benefits from lower reservable deposits and hence lower reserve requirements.

Over the past two years, banks primarily have adopted one of the following two types of consumer-related sweeps: a NOW sweep or a weekend sweep. The most common is the NOW sweep. This transaction involves two separate sub-accounts, a NOW and an MMDA. At the starting date, the bank will shift funds in excess of a designated minimum from a NOW balance into an MMDA. In subsequent days, if presentments happen to exceed the account holder's NOW balance, amounts sufficient to pay the presented items and restore the minimum NOW balance are then transferred from the customer's MMDA to the NOW account. This process continues until the sixth transfer, the legal maximum, when all the remaining swept balances in the MMDA are transferred back to the NOW account. They are then left in the NOW until the start of the new month, when the cycle begins all over again.

The second type of sweep, the weekend sweep, is a hybrid of the NOW sweep. As represented by the title, fund transfers are limited to weekends. At the close of business on a Friday, entire balances are shifted from NOW accounts into MMDAs. These are transferred back on Monday or on the first business day after the weekend. The net impact is that reservable deposits are reduced on three of the seven days of the week. In addition, the number of sweeps per month does not need to be monitored because the maximum allowable number, six, exceeds the largest possible number of weekends. Only about 10 percent of sweeps are weekend sweeps, and most banks initiating this activity have indicated that these sweeps are an interim step toward a full-time sweep arrangement.

Table 1

SPECIFICATIONS FROM DIRECTIVES OF THE FEDERAL OPEN
MARKET COMMITTEE AND RELATED INFORMATION

Date of Meeting	Discount Rate (Percent)	Expected Federal Funds Rate (Percent)	Borrowing Allowance for Deriving NBR Path (Millions of Dollars) ^a
12/20/94	4.75	5.50	125 100 on 1/5 ^b 75 on 1/12 ^b
1/31 to 2/1/95	5.25 on 2/1	6 on 2/1	75 on 2/1 ^c
3/28/95	5.25	6	75 100 on 4/13 ^b 150 on 4/27 ^b 175 on 5/11 ^b
5/23/95	5.25	6	175 225 on 6/22 ^b
7/5 to 7/6/95	5.25	5.75 on 7/6	250 on 7/6 ^d 275 on 7/20 ^b
8/22/95	5.25	5.75	275
9/26/95	5.25	5.75	275 250 on 10/12 ^b 200 on 10/26 ^b 100 on 11/9 ^b
11/15/95	5.25	5.75	100 75 on 11/24 ^b
12/19/95	5.25	5.50 on 12/19	75 ^e

^a The borrowing allowance associated with the expected federal funds rate.

^b Change in borrowing assumption reflects technical adjustment to account for actual or prospective behavior of seasonal borrowing.

^c The assumption was unchanged because the full effect of the discount rate increase was allowed to show through to the federal funds rate.

^d The change in reserve pressures was not expected to have an impact on borrowing. This change in the borrowing assumption reflects a technical adjustment to account for actual or prospective behavior of seasonal borrowing.

^e The allowance was unchanged because the change in reserve pressures was not expected to have an impact on borrowing.

Table 2

REQUIRED RESERVES AND FACTORS AFFECTING NONBORROWED RESERVES

Billions of Dollars

	Maintenance Period Ended 1/3/96	Change during	
		1995 ^a	1994 ^b
Required Reserves	57.3	(3.1)	(2.0)
Operating Factors ^c			
Foreign currency ^d	16.4	(0.9)	(2.1)
U.S. currency in circulation	423.4	(20.4)	(37.2)
Treasury balance	6.7	0.3	1.4
Float	0.9	0.2	(0.6)
Special drawing rights	10.2	2.1	0.0
Foreign deposits	0.2	0.0	(0.1)
Applied vault cash	37.4	0.9	3.2
Foreign RP pool ^e	12.5	(4.4)	(0.6)
Required clearing balances ^f	5.2	(1.0)	2.1
Other items	21.1	0.2	2.1

^a Change from maintenance period ended January 4, 1995 to that ended January 3, 1996.

^b Change from maintenance period ended January 5, 1994 to that ended January 4, 1995.

^c Sign indicates impact of changes in operating factors on reserves. All items are biweekly averages.

^d Acquisition value plus interest. Revaluations of foreign currency holdings are included in "Other items."

^e Includes customer-related repurchase agreements.

^f Clearing balances are a source of reserve demand, but in this accounting framework they are counted as a charge against nonborrowed reserves.

Note: Declines in holdings are shown in parentheses.

Table 3
AVERAGE EXCESS RESERVE HOLDINGS
Millions of Dollars

	1990	1991	1992	1993	1994	1995
All depository institutions						
Period average	933	1,206	1,020	1,083	1,074	988
First week	804	845	376	169	691	540
Second week	1,062	1,567	1,664	1,997	1,457	1,437
Settlement day	2,674	5,022	4,292	3,422	630	4,040
Large institutions						
Period average	68	157	79	66	78	49
First week	(65)	(103)	(439)	(659)	(138)	(197)
Second week	200	416	597	791	295	294
Settlement day	1,078	2,987	2,322	1,243	(1,184)	1960
Small institutions						
Period average	865	1,049	940	1,017	995	940
First week	869	948	815	828	828	737
Second week	862	1,151	1,066	1,206	1,163	1,143
Settlement day	1,596	2,035	1,970	2,179	1,814	2,080

Notes: Negative numbers are in parentheses. Each calendar year includes all maintenance periods having its settlement day in that year.

APPENDIX: FORECAST ACCURACY

On average, the accuracy of the projections of market factors during 1995 was comparable to the 1994 performance at each stage of the maintenance period. Improvements in forecasting the Treasury balance were counterbalanced by a slight deterioration in forecasting currency and the foreign RP pool (see table below).

In general, forecasts of required reserves during 1995 were mildly better than 1994 projections: forecasts made at the beginning and middle of the maintenance period improved in 1995 relative to 1994, while those made at the end of the period were only slightly worse. As noted above, required reserves registered a sizeable decline in 1995 as a result of sweep accounts; however, because advance notice of the timing of these sweeps was generally available, this information was incorporated into the projections of deposits and required reserves at the start of a period.

Estimates of the Treasury's balance at the Fed made on the first day of the maintenance period showed dramatic improvement in 1995 relative to 1994. The largest errors were in the periods around the April and June tax payment dates. During these times, the Treasury's cash balance often exceeded the capacity in the Treasury tax and loan note accounts at commercial banks.⁷

Projections of currency made on the first day of the maintenance period were slightly worse during 1995 than in 1994. Most of the errors occurred in maintenance periods when a typical build-up in currency was expected but did not happen. The weaker growth was related in part to reduced foreign demand, which was consistent with increased economic stability in several foreign economies where demand for U.S. currency previously had been strong.

APPROXIMATE MEAN ABSOLUTE ERRORS FOR FORECASTS OF RESERVES AND VARIOUS OPERATING FACTORS

Millions of Dollars

	1995			1994		
	First Day	Midperiod	Final Day	First Day	Midperiod	Final Day
Required Reserves	235-280	135	70	285-340	160-170	40-65
Factors	710-740	415-525	65-70	710-750	425-465	65-75
Treasury	385-390	285-290	50-60	610	285-305	45-50
Currency	550-690	175-255	20-40	500-515	180-205	15-25
Float	215-240	135-155	30-50	220-250	140-160	25-45
Pool	340	155	10	240	90	10
Other items	175	110	50	190	90	35

Note: Rounded to the nearest \$5 million. A range indicates different errors for the New York Reserve Bank and Board of Governors staffs' forecasts.

ENDNOTES

1. With a borrowed reserves objective, monetary policy actions giving rise to a change in the spread between the funds and discount rates normally would lead to a new borrowing allowance being incorporated in the path. But reflecting the more recent behavior of adjustment borrowing, this allowance was not changed for the two policy easings implemented in 1995. The Desk continued to make changes to reflect actual or anticipated movements in the seasonal component of the borrowing allowance.
2. Investments in the pool drain reserves when foreign institutions shift dollar holdings into their Federal Reserve accounts, which are then invested on an overnight basis by purchasing some of the System's securities.
3. The Desk bought \$4.5 billion (par value) of coupon securities on April 4, \$4.4 billion of Treasury bills on May 31, and \$3.8 billion of bills on November 8. Then, in four linked operations from November 30 through December 6, the Desk purchased a total of \$4.6 billion of coupon issues. The Desk's new method of arranging outright coupon transactions is described below.
4. Most operating factors affecting nonborrowed reserve supplies are subject to revision at any point in the period. The estimates of required reserves and applied vault cash for the two-week period are updated on each Tuesday, Wednesday, and Thursday. Revisions coming late in the period can significantly affect the remaining need.
5. Consumer sweep activity is relatively new, facilitated by more sophisticated computer systems at banks. Banks have a long history of shifting, or "sweeping" account balances of businesses, justified on a cost basis by the large volume transfers that are made. In a business sweep, deposits are usually transferred from a demand deposit account into nonreservable investments such as repurchase agreements.
6. Sweep calculations are based on the amount a depository institution transferred at the initiation of the program. Amounts that have been subsequently transferred at that institution are not available.
7. There were sixteen days in 1995 when the Treasury's overall cash balance exceeded the target Federal Reserve balance plus the capacity in the Treasury tax and loan note accounts, which is comparable to 1994 when this capacity was exceeded on fourteen days.

TREASURY AND FEDERAL RESERVE
FOREIGN EXCHANGE OPERATIONS

TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS FOR 1995: AN OVERVIEW

During 1995, the dollar declined 7.4 percent against the German mark and 4.8 percent on a trade weighted basis, but appreciated by 3.7 percent against the Japanese yen. Against the Canadian dollar and Mexican peso, the dollar ended 1995 2.7 percent weaker and 58.8 percent stronger, respectively. Over the course of the year, the U.S. monetary authorities intervened in the foreign exchange markets on eight occasions—March 2, March 3, April 3, April 5, May 31, July 7, August 2, and August 15—purchasing a total of approximately \$6.6 billion against the mark and the yen (see table). All of these purchases were equally divided between the Treasury Department's Exchange Stabilization Fund (ESF) and the Federal Reserve System. In other operations, the Mexican authorities drew a total of \$1.5 billion against Federal Reserve System short-term swap lines and \$12 billion against short- and medium-term ESF swap lines in 1995. During that period, Mexico repaid a total of \$1.7 billion in principal, allocated equally between the ESF and the Federal Reserve System swap lines. A more detailed discussion of these operations can be found in the quarterly foreign exchange reports that follow.

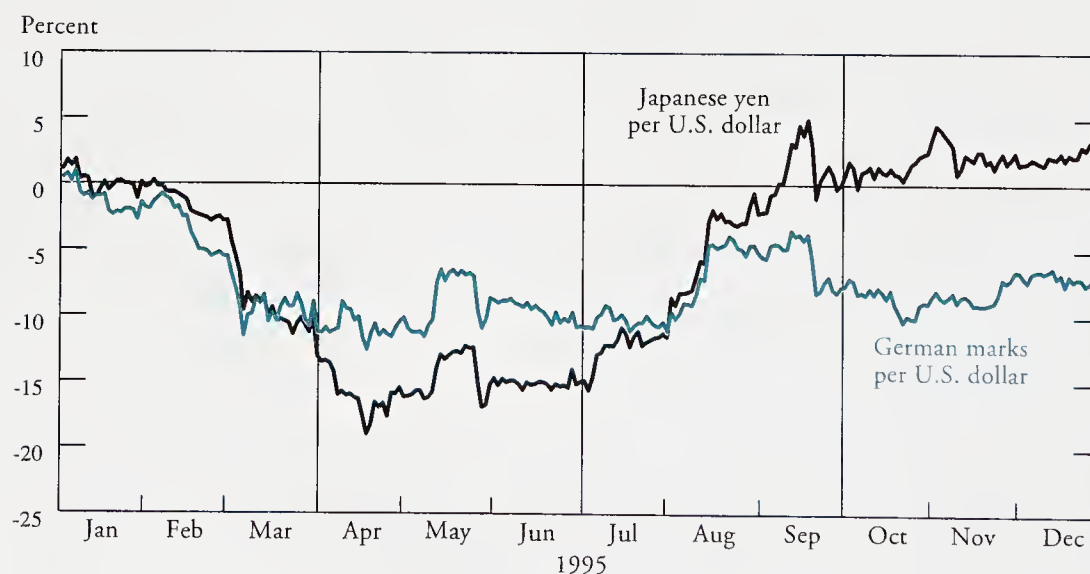
U.S. FOREIGN EXCHANGE INTERVENTION ACTIVITY DURING 1995

Millions of Dollars

Dollar Purchases (+) or Sales (-)	Against the Mark	Against the Yen	Total
March 2	+300	+300	+600
March 3	+450	+370	+820
April 3	+750	+750	+1500
April 5	+850	+250	+1100
May 31	+500	+500	+1000
July 7		+333.3	+333.3
August 2		+500	+500
August 15	+400	+300	+700
Total	+3250	+3303.3	+6553.3

PERCENTAGE CHANGE IN THE DOLLAR DURING 1995

Spot Exchange Rate



Source: Federal Reserve Bank of New York.

TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

January–March 1995

During the first quarter of 1995, the dollar declined 11.3 percent against the German mark, 13.1 percent against the Japanese yen, 0.2 percent against the Canadian dollar, and 7.8 percent on a trade-weighted basis. On March 2, the U.S. monetary authorities intervened in the foreign exchange markets, purchasing \$300 million against the Japanese yen and an equal amount against the German mark. The U.S. monetary authorities entered the market again on March 3, purchasing \$450 million against the German mark and \$370 million against the Japanese yen as part of a concerted operation to support the dollar. In other operations, Mexico drew a net \$1 billion on its swap facility with the Federal Reserve and a net \$4 billion on the Treasury Department's Exchange Stabilization Fund (ESF), of which a net \$1 billion represented drawings from short-term facilities and \$3 billion from the ESF's medium-term facility. These drawings were part of the \$20 billion financial aid package to Mexico announced by the Clinton Administration on January 31 and signed on February 21.

SHIFTING EXPECTATIONS TAKE THE DOLLAR TO NEW LOWS

At the end of 1994, many market participants expected the dollar to continue to appreciate into 1995. These expectations were based on a belief that short-term U.S. interest rates would continue to rise and, as a result, interest rate differentials would widen in the dollar's favor. German monetary policy was expected to remain steady through the first part of 1995, in turn suggesting that exchange rate movements within Europe would remain subdued. At the same time, market participants anticipated that Japan's current account surplus would contract as Japan's

This report, presented by Peter R. Fisher, Executive Vice President, Federal Reserve Bank of New York, and Manager, System Open Market Account, describes the foreign exchange operations of the U.S. Department of the Treasury and the Federal Reserve System for the period from January 1995 through March 1995. Claudia Corra was primarily responsible for preparation of the report.

economic recovery took hold in 1995, while the U.S. current account deficit would stabilize. During the first quarter of 1995, however, the expectations that had supported the dollar in late 1994 started to unwind, and the dollar declined to historical lows against the mark and the yen.

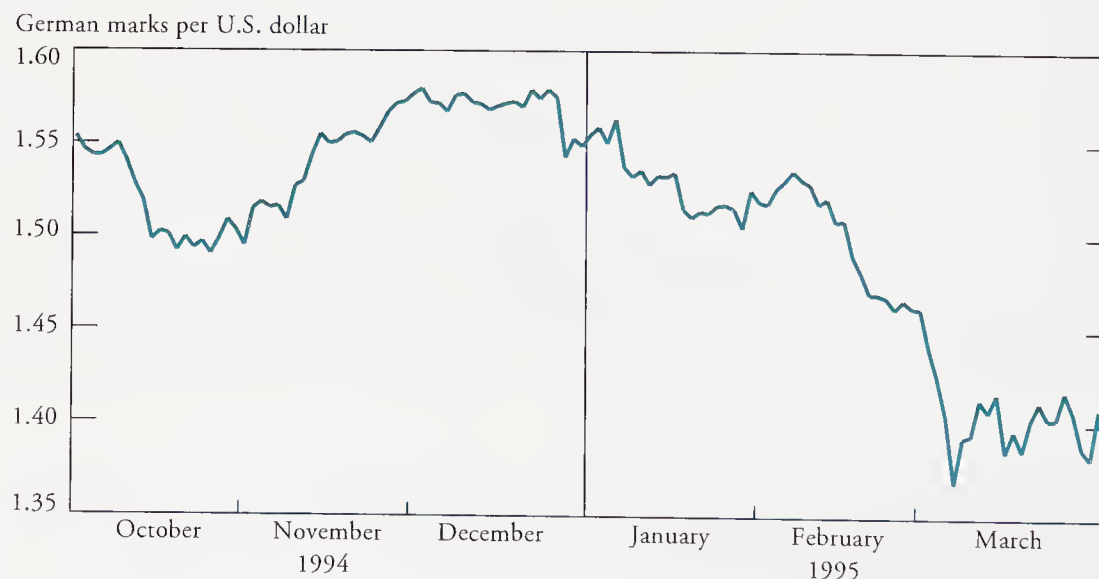
U.S. INTEREST RATE EXPECTATIONS SUBSIDE WHILE THE MARK STRENGTHENS WITHIN EUROPE

Having closed the previous quarter at DM 1.5490 and ¥99.55, the dollar declined in a steady but orderly fashion through mid-February, falling 4.4 percent against the mark to DM 1.4810 and 2.3 percent against the yen to ¥97.27. The decline reflected various factors operating in the economies of the major currencies. In the United States, lower than expected housing, retail sales, and nonfarm payroll data provided initial signs that economic growth was slowing to more sustainable levels. Expectations for additional U.S. interest rate increases faded further after the January 31–February 1 Federal Open Market Committee (FOMC) meeting, at which the Federal Reserve decided to raise both the discount and federal funds rates 50 basis points to 5.25 and 6.00 percent, respectively. Following this hike, market participants came to expect that monetary policy would remain on hold through the March FOMC meeting and possibly through the May meeting as well. This downward revision in expected U.S. interest rates contributed to the dollar's decline. In Europe, the German mark began to appreciate sharply against other European currencies. The prospect of higher than expected wage settlements in Germany and upward trending German producer price data led many market participants to expect an end to the Bundesbank's

Chart 1

THE DOLLAR AGAINST THE GERMAN MARK

Spot Exchange Rate



Source: Federal Reserve Bank of New York.

easing cycle or perhaps even a near-term tightening. Perceived political and fiscal problems in Italy, Sweden, and Spain led to some flight to the German mark from the Italian lira, Swedish krona, and Spanish peseta.

In Japan, analysts began to revise down their near-term forecasts for Japanese growth following the country's severe earthquake on January 17. Moreover, Japanese economic data provided continuing evidence of weak domestic demand. As concerns over another postponement in Japan's economic recovery spread, Japanese stocks came under selling pressure and the Japanese bond market began a sustained rally. The announcement that Barings PLC was being placed in administration, together with the subsequent liquidation of the firm's long positions in Nikkei stock index futures, placed additional short-term pressure on Japanese stocks.

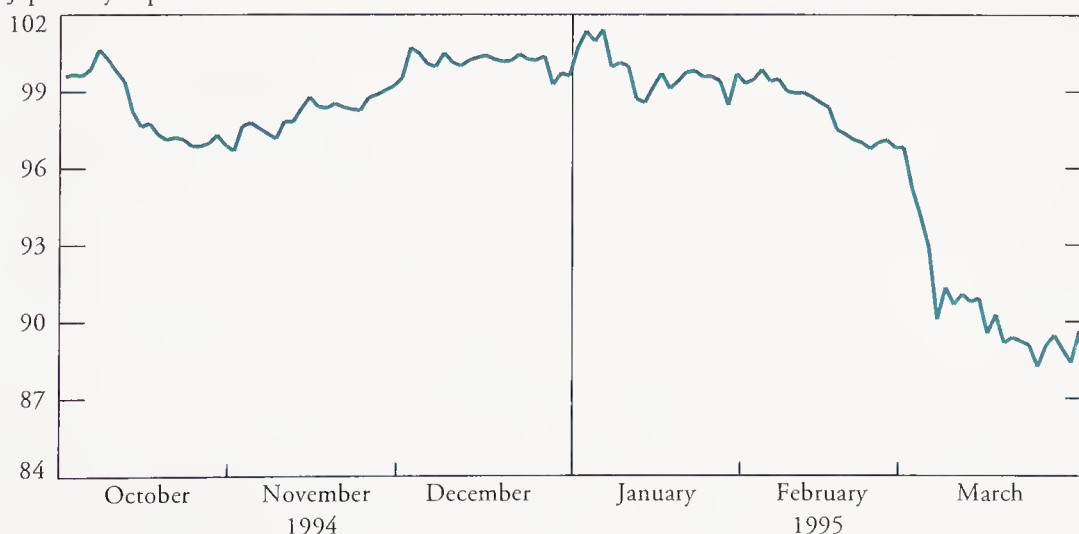
Throughout the early part of the quarter, the Mexican financial crisis also hurt dollar sentiment in at least two ways. First, the U.S. trade deficit was expected to increase as a result of a protracted economic crisis in Mexico, adding pressure to the dollar. Second, the Mexico crisis, coupled with weaker Canadian financial markets, caused many overseas investors to develop an aversion to all North American assets, including dollar-denominated assets. Moreover, that aversion grew as the availability and viability of the first U.S. financial assistance package, which was initially reported on January 11, appeared to be losing congressional support. Sentiment turned more positive with the January 31 announcement of a second package that also included funds from the

Chart 2

THE DOLLAR AGAINST THE JAPANESE YEN

Spot Exchange Rate

Japanese yen per U.S. dollar



Source: Federal Reserve Bank of New York.

International Monetary Fund (IMF) and the Bank for International Settlements (BIS). Nonetheless, continued political debate within the United States over the existence and size of the assistance package continued to weigh on market sentiment during much of February.

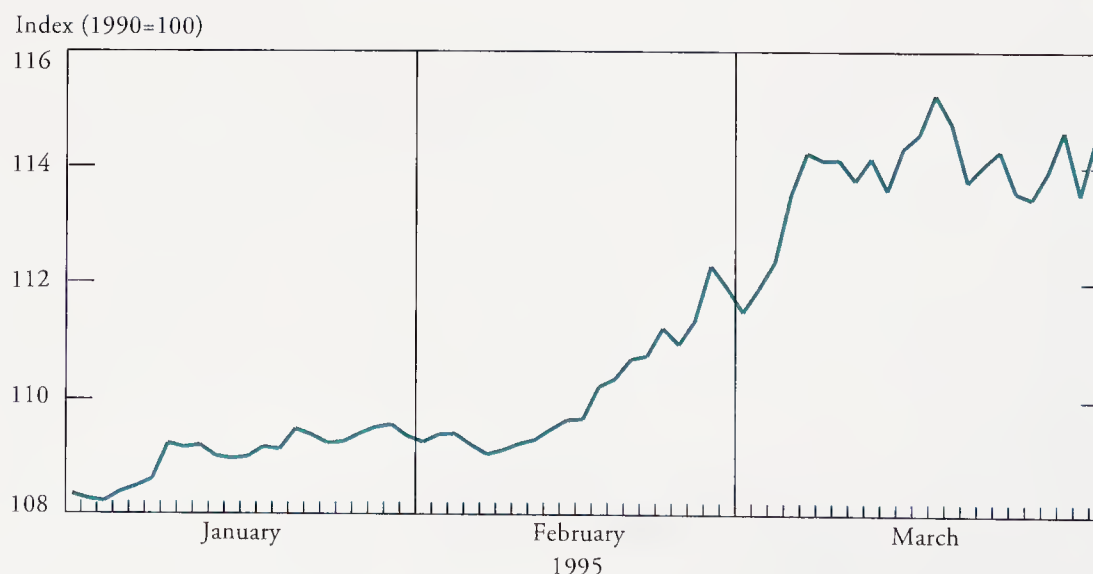
By February 17, the dollar traded to DM 1.4810, a level last reached in October 1992, and declined to ¥97.27, a level last reached on November 9, 1994.

THE DOLLAR'S DECLINE ACCELERATES IN LATE FEBRUARY

Starting in late February, the pace of the dollar's decline accelerated. First, comments by Federal Reserve officials reinforced the perception among market participants that the central bank might be nearing, or might even have reached, the end of its tightening cycle. In particular, market participants interpreted comments by Federal Reserve Chairman Greenspan during his semiannual Humphrey-Hawkins testimony on February 22 as suggesting a significant change in tone. Attention focused almost exclusively on the Chairman's comment that "there may come a time when we hold our policy stance unchanged, or even ease, despite adverse price data, should we see signs that underlying forces are acting ultimately to reduce inflationary pressures."

Second, pressure within Europe's Exchange Rate Mechanism (ERM) continued to build, spurring demand for marks and taking the German currency to an all-time high on a trade-weighted basis. In addition to the persistent strains on the Italian lira, the Swedish krona, and the Spanish peseta, the French franc came under pressure amid increased uncertainty ahead of the two-round

Chart 3
THE TRADE-WEIGHTED GERMAN MARK



presidential election in April and May, while sterling declined because of the perceived weakness of Prime Minister Major's government. Third, expectations that dollar sales by Japanese corporations and financial institutions would accelerate up to the March 31 Japanese fiscal year-end also weighed on the dollar.

Several discrete factors contributed to negative dollar sentiment in late February. First, comments by several Federal Reserve officials between February 28 and March 2 were perceived by market participants as suggesting a lack of official concern over the value of the dollar. Second, the defeat of the Balanced Budget Amendment created the perception—particularly among overseas investors—that the United States lacked the political will to reduce its chronic fiscal deficit. Third, press reports suggesting that the United States would adopt a tougher stance toward Japan in ongoing trade talks also contributed to the dollar's weakness.

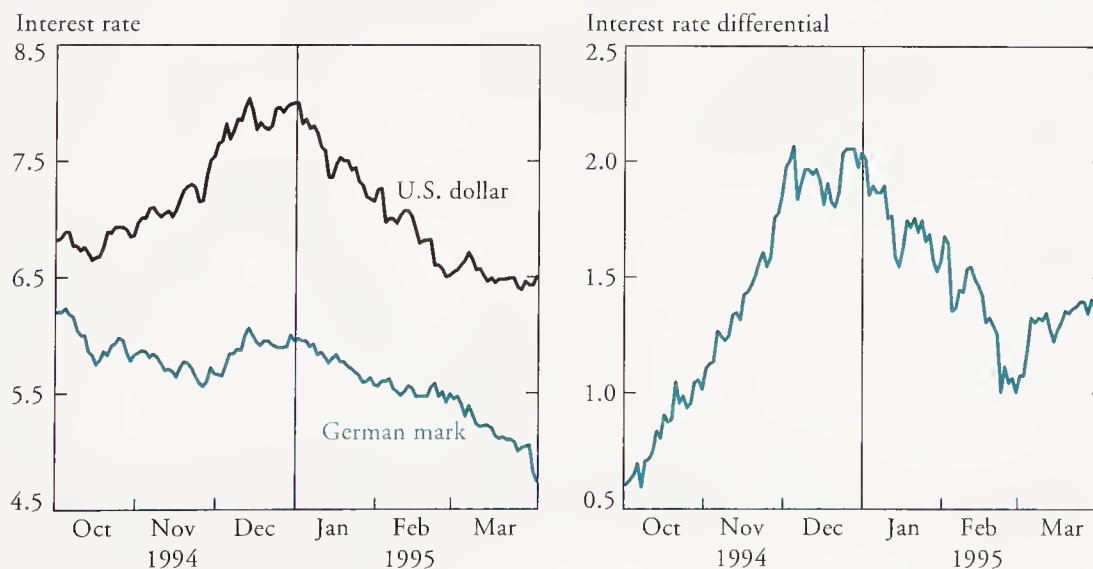
U.S. MONETARY AUTHORITIES BUY DOLLARS AGAINST THE MARK AND YEN

As the dollar's decline accelerated in late February and early March, portfolio managers began to liquidate substantial long-dollar positions. Against a backdrop of reduced liquidity and limited risk appetite, these flows added considerable momentum to the dollar's decline. Moreover, as the dollar breached certain levels, some market participants were knocked out of their options positions, forcing them to sell dollars quickly to reestablish protection against an even weaker dollar.

Chart 4

DIFFERENTIAL BETWEEN DOLLAR AND GERMAN MARK SHORT-TERM INTEREST RATES

Implied by the Three-Month Eurodeposit Futures (June 1995 Contracts)



Source: Bloomberg L.P.

On the morning of Thursday, March 2, in nervous and illiquid market conditions, the dollar fell precipitously, first against the yen and then against the mark. By midday, the dollar had reached lows of ¥94.93 and DM 1.4348, declines of almost two yen and three pfennigs, respectively, from the previous day's closing levels. That afternoon, the Federal Reserve Bank of New York's Foreign Exchange Desk entered the market on behalf of the U.S. monetary authorities, purchasing \$300 million against the German mark and \$300 million against the Japanese yen in an effort to help stabilize the currency. The purchases were divided evenly between the Federal Reserve and the Department of the Treasury's ESF. The dollar reached highs of DM 1.4463 and ¥95.49 after the Desk entered the market, but closed the day at DM 1.4410 and ¥95.15.

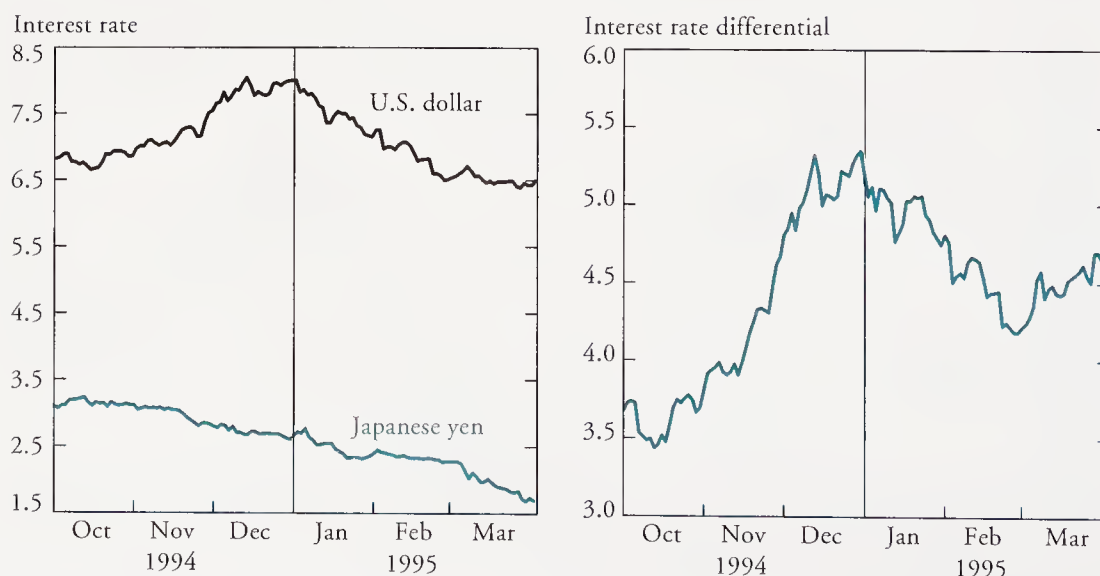
On Friday, March 3, in early European trading, a number of European central banks intervened in concert to support the dollar. Later that day, at about 9:10 a.m., with the dollar trading at DM 1.4490 and ¥94.80, the Desk entered the market to purchase dollars against marks and yen on behalf of the U.S. monetary authorities. The Desk was joined by thirteen other central banks in a concerted effort to support the dollar. Also on March 3, Treasury Secretary Rubin confirmed the U.S. intervention and highlighted official concern over the dollar's recent decline by stating that:

"A strong dollar is in our national interest. That is why we have acted in the markets in concert with others. The Administration is continuing its work on strengthening economic fundamentals including bringing down the budget deficit further."

Chart 5

DIFFERENTIAL BETWEEN DOLLAR AND JAPANESE YEN SHORT-TERM INTEREST RATES

Implied by the Three-Month Eurodeposit Futures (June 1995 Contracts)



Source: Bloomberg L.P.

During the day, the Desk purchased \$450 million against the German mark and \$370 million against the Japanese yen. All the dollar purchases were divided equally between the Federal Reserve and the ESF. Throughout the day, the dollar met aggressive selling interest by market participants and proceeded to trade progressively lower, closing at DM 1.4250 and ¥94.08.

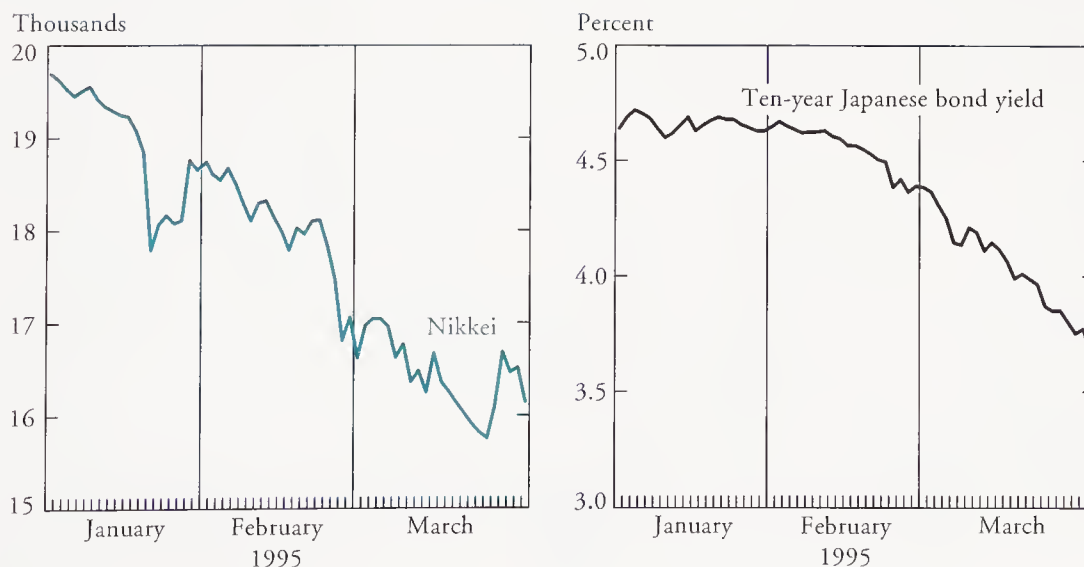
THE DOLLAR EVENTUALLY STABILIZES AGAINST THE MARK BUT REMAINS UNDER PRESSURE AGAINST THE YEN

In the week immediately following the intervention, the dollar continued to decline rapidly against the mark and the yen. Demand for marks increased following the March 5 realignment of the ERM, in which the central parity of the Spanish peseta was effectively devalued by 7 percent and that of the Portuguese escudo by 3.5 percent. On Wednesday, March 8, during Asian trading hours, the dollar reached new historical lows of DM 1.3438 and ¥88.72.

The dollar started to stabilize later that day, following official interest rate increases in several European countries and dollar-supportive statements by senior monetary officials. On March 8, France, Belgium, Denmark, and Portugal increased official short-term interest rates in an attempt to alleviate pressure on their currencies. Soon thereafter, Bundesbank President Tietmeyer stated that the Bundesbank would see if there was “room for a small interest rate cut,” but added that the Bundesbank would also consider the possibility of raising interest rates. Market participants noted that this was the first time in several months that President Tietmeyer had mentioned the

Chart 6

THE NIKKEI STOCK MARKET INDEX AND TEN-YEAR JAPANESE GOVERNMENT BOND YIELDS



Source: Bloomberg L.P.

possibility of another interest rate cut in Germany. Tietmeyer later added, “In my view, the dollar was, and still is, undervalued. The deutsche mark is valued too high.”

That same day, speaking before the House Budget Committee, Chairman Greenspan said: “The weakness of the dollar against other major currencies is both unwelcome and troublesome. Dollar weakness, while very likely overdone, is unwelcome because it adds to potential inflation pressures in our economy.” Market participants reacted positively to Chairman Greenspan’s comments, as well as to additional dollar-supportive comments by Treasury Secretary Rubin, because these statements helped assuage concerns that U.S. officials were unconcerned about the dollar. Over the rest of the period, the dollar traded in a range of DM 1.3730 to DM 1.4225 against the mark.

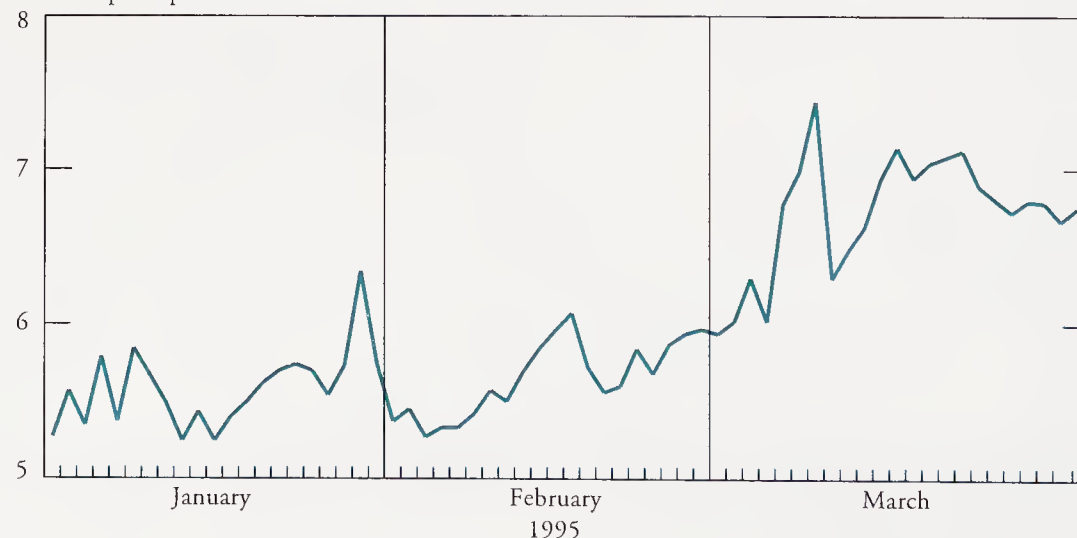
Despite its modest rebound against the mark, the dollar remained under pressure against the yen throughout March. Sentiment toward the dollar continued to be negative as market participants focused on reports of capital repatriation by Japanese financial institutions and of dollar sales by Asian central banks looking to rebalance reserves or cover yen-denominated liabilities. In addition, continued concerns about the Japanese current account surplus caused the yen to appreciate sharply against the dollar. This upward pressure on the yen continued despite rising speculation of an imminent cut in the Bank of Japan’s official discount rate (ODR).

Chart 7

THE DOLLAR AGAINST THE MEXICAN PESO

Spot Exchange Rate

Mexican pesos per U.S. dollar



Source: Federal Reserve Bank of New York.

Following the March 28 FOMC meeting, at which no monetary policy announcement was made, the dollar continued to drift lower. Although market participants expected monetary policy to remain steady, weak data on durable goods and home sales provided additional evidence of slower growth, further solidifying market participants' views that the United States was approaching the end of its tightening cycle.

On March 30, the Bundesbank surprised the markets with a 50 basis point cut in its discount rate, to 4 percent, and a 35 basis point cut in its repurchase rate for government securities, which had been fixed at 4.85 percent since July 1994. The announcement supported the dollar for a time, but the rally was short-lived as the dollar failed to break out of its March trading range, prompting fresh dollar sales. The following day, March 31, the Bank of Japan allowed its overnight call rate to fall to a historical low of 1.75 percent. Upward pressure on the yen continued, however, with market participants expressing disappointment that the ODR had not been reduced. The dollar proceeded to fall to a new postwar low of ¥86.30 on March 31 in somewhat illiquid trading conditions. The dollar closed the quarter at DM 1.3735 and ¥86.50.

MEXICAN FINANCIAL MARKETS REMAIN VOLATILE

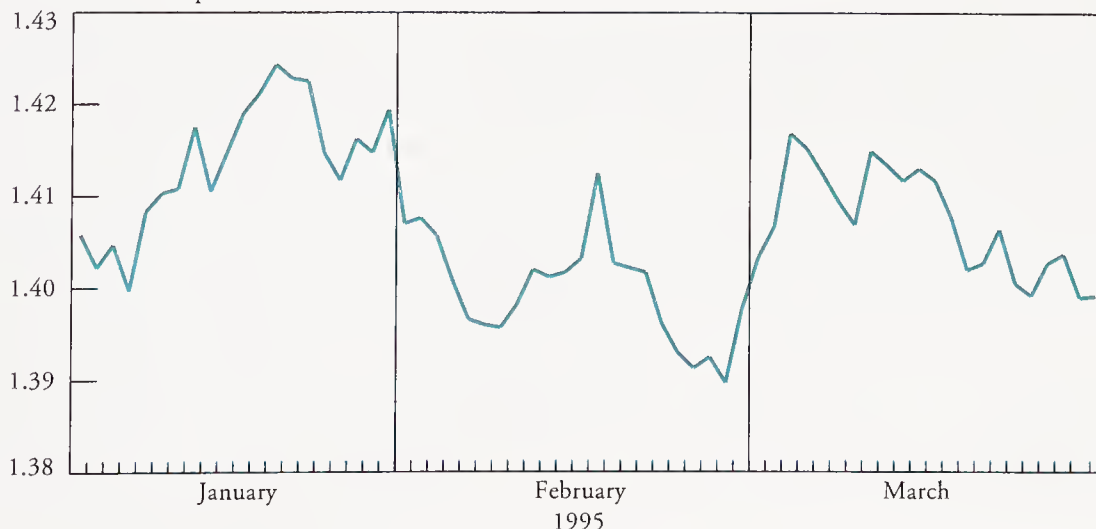
Over the period, the dollar rose 39.4 percent against the peso. The new peso reached a record low of NP 7.65 on March 9 before recovering somewhat during the latter part of the period. As the period opened, uncertainty over the course of Mexican macroeconomic policy and concerns over

Chart 8

THE DOLLAR AGAINST THE CANADIAN DOLLAR

Spot Exchange Rate

Canadian dollars per U.S. dollar



Source: Federal Reserve Bank of New York.

the impact of the devaluation on Mexico's banking sector led market participants to attach a substantial risk premium to Mexican financial assets, exacerbating already difficult trading conditions in Mexican money and foreign exchange markets.

During the ensuing weeks, Mexican financial markets remained under pressure amid growing doubts about the prospects for congressional passage of the U.S. \$40 billion loan guarantee package. On January 31, President Clinton announced a new \$47.8 billion aid package that included participation by the IMF and BIS. Mexican markets initially rallied on the announcement but remained volatile amid worries that the second package might be subject to congressional challenge.

Mexican financial markets started to recover in early March following the signing, on February 21, of the \$20 billion U.S. portion of the package. Other factors also provided support, including Finance Minister Ortiz's announcement of a strict new economic program, which was well received by the financial community, and the Bank of Mexico's announcement of its intention to follow a tight and more transparent monetary policy. For the rest of the quarter, Mexican markets remained nervous but traded with a somewhat firmer tone. The peso closed the period at NP 6.76 per dollar.

MEXICAN SWAP LINE ACTIVITY

During the period, the U.S. monetary authorities substantially increased their swap lines with Mexico, which had stood at \$6 billion at the start of the period. Temporary short-term swap lines were established on January 2 as the Federal Reserve agreed to a \$1.5 billion facility with the Bank of Mexico and the ESF agreed to a facility of the same amount with the Mexican central bank and government. The Federal Reserve's temporary facility was later increased to \$3 billion on February 1.

In addition, as part of the U.S. financial package signed on February 21, the ESF established a medium-term swap facility with the Mexican government. The facility allows Mexico to draw up to \$20 billion, less the amounts outstanding from short-term swaps and securities guarantees.

The Mexican authorities drew on both short- and medium-term facilities during the period. On two separate occasions, January 11 and 13, Mexico drew \$250 million from each of its regular short-term facilities with the Federal Reserve and the ESF. Then, for value February 2, Mexico drew \$1 billion from each regular short-term facility. Mexico drew \$3 billion from the medium-term facility on March 14 and on the same date repaid in full the January drawings.

CANADIAN FINANCIAL MARKETS REMAIN UNDER PRESSURE

During the period, the Canadian dollar reached a nine-year low of C\$1.4272 against the U.S. dollar before recovering late in the quarter to close relatively unchanged at C\$1.3990. Canadian financial markets remained under pressure because of ongoing fiscal concerns, fears of Quebec separatism, and spillover from developments in Mexico and the United States. Moody's announcement that it was reviewing Canada's foreign and domestic debt rating for a possible downgrade heightened the negative sentiment.

Canada's fiscal year 1995-96 budget, released on February 27, was well received by the market since it met the planned 1996 target of 3 percent of GDP and focused on increased spending cuts. The post-budget rally was short-lived, however, as market participants increasingly began to hold the view that the budget did not adequately address Canada's underlying fiscal trends. During the latter part of the period, Canadian financial markets started to recover once market participants had discounted the possibility of a Moody's downgrade. Canadian markets also benefited toward the end of the period as concerns about Quebec separatism receded.

TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE RESERVES

The U.S. monetary authorities intervened twice during the period, buying a total of \$1.42 billion against the Japanese yen and German mark. On both occasions, intervention operations were financed equally by the Federal Reserve and the Treasury Department's ESF. The Federal Reserve and the ESF realized total profits of \$187.2 million and \$164.1 million, respectively, on their intervention operations. Realized profits and losses on sales of foreign currencies are computed as the difference between historic cost-of-acquisition exchange rates and sale exchange rates.

At the end of the period, the current values of the foreign exchange reserve holdings of the Federal Reserve and the ESF were \$25.3 billion and \$25.4 billion, respectively. The U.S. monetary authorities regularly invest their foreign currency balances in a variety of instruments that yield market-related rates of return and have a high degree of liquidity and credit quality. A portion of the balances is invested in foreign government-issued securities. As of March 31, the Federal Reserve and the ESF held, either directly or under repurchase agreement, \$9.7 billion and \$13.8 billion respectively, in foreign government securities.

Table 1

FOREIGN CURRENCY HOLDINGS OF U.S. MONETARY
AUTHORITIES BASED ON CURRENT EXCHANGE RATES

Millions of Dollars

		Quarterly Changes in Balances by Source				
	Balances as of December 31, 1994	Net Purchases and Sales ^a	Impact of Sales ^b	Investment Income	Currency Valuation Adjustments ^c	Balances as of March 31, 1995
Federal Reserve						
Deutsche marks	13,405.2	(375.0)	3.4	188.7	1,655.0	14,877.3
Japanese yen	8,510.0	(335.2)	5.3	23.1	1,213.7	9,416.9
Mexican pesos ^d	0.0	995.1	0.0	4.9	(134.9) ^e	865.1
Subtotal	21,915.2	284.9	8.6	216.7	2,733.8	25,159.2
Interest receivables ^f	116.3					127.3
Total	22,031.5					25,286.5
U.S. Treasury						
Exchange Stabilization Fund						
Deutsche marks	7,500.6	(375.0)	3.4	103.2	916.6	8,148.8
Japanese yen	11,801.0	(335.2)	5.3	29.1	1,696.1	13,196.3
Mexican pesos ^d	0.0	3,983.6	0.0	16.4	0.0 ^e	4,000.0
Subtotal	19,301.6	3,273.5	8.6	148.7	2,612.8	25,345.2
Interest receivables ^f	64.9					88.0
Total	19,366.5					25,433.2

Note: Figures might not sum because of rounding.

^a Purchases and sales for the purpose of this table include foreign currency sales and purchases related to official activity, swap drawings and repayments, and warehousing.^b This number is calculated using marked-to-market exchange rates; it represents the difference between the sale exchange rate and the most recent revaluation exchange rate. Realized profits and losses on sales of foreign currencies, computed as the difference between the historic cost-of-acquisition exchange rate and the sale exchange rate, are reflected in Table 2.^c Foreign currency balances are marked-to-market monthly at month-end exchange rates.^d See Table 4 for a breakdown of Mexican swap activities. Note that the investment income on Mexican swaps is sold back to the Bank of Mexico.^e Valuation adjustments on peso balances do not affect profit and loss because the impact is offset by the unwinding of the forward contract at the repayment date. Note that the ESF does not mark-to-market its peso holdings, but the Federal Reserve System does.^f Interest receivables for the ESF are revalued at month-end exchange rates. Interest receivables for the Federal Reserve System are carried at cost and are not marked-to-market until interest is paid.

Table 2

NET PROFITS (+) OR LOSSES (-) ON U. S. TREASURY AND
FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS BASED ON
HISTORIC COST-OF-ACQUISITION EXCHANGE RATES

Millions of Dollars

	Federal Reserve	U.S. Treasury Exchange Stabilization Fund
Valuation profits and losses on outstanding assets and liabilities as of December 31, 1994		
Deutsche marks	2,170.4	708.1
Japanese yen	2,407.2	3,344.4
Total	4,577.6	4,052.4
Realized profits and losses from foreign currency sales ^a		
December 31, 1994 - March 31, 1995		
Deutsche marks	81.6	58.2
Japanese yen	105.6	105.9
Total	187.2	164.1
Valuation profits and losses on outstanding assets and liabilities as of March 31, 1995 ^b		
Deutsche marks	3,747.2	1,569.8
Japanese yen	3,520.5	4,939.9
Total	7,267.7	6,509.8

^a As indicated in Table 1, foreign currency sales totaled \$750.0 million against German marks and \$670.4 million against Japanese yen.

^b Valuation profits or losses are not impacted by peso holdings, which are canceled by forward contracts.

Table 3

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

<u>Institution</u>	<u>Amount of Facility</u>	<u>Outstanding as of March 31, 1995</u>
Austrian National Bank	250	0
National Bank of Belgium	1,000	0
Bank of Canada	2,000	0
National Bank of Denmark	250	0
Bank of England	3,000	0
Bank of France	2,000	0
Deutsche Bundesbank	6,000	0
Bank of Italy	3,000	0
Bank of Japan	5,000	0
Bank of Mexico ^a		
Regular swaps	3,000	1,000
Temporary swaps	3,000	0
Netherlands Bank	500	0
Bank of Norway	250	0
Bank of Sweden	300	0
Swiss National Bank	4,000	0
Bank for International Settlements		
Dollars against Swiss francs	600	0
Dollars against other authorized European currencies	1,250	0
Total	35,400	1,000

**U.S. TREASURY EXCHANGE STABILIZATION FUND CURRENCY
ARRANGEMENTS**

Millions of Dollars

<u>Institution</u>	<u>Amount of Facility</u>	<u>Outstanding as of March 31, 1995</u>
Deutsche Bundesbank	1,000	0
Bank of Mexico ^a		
Regular Swaps	3,000	1,000
Temporary Swaps	1,500	0
United Mexican States ^a		
Medium-Term Swaps		3,000
Total ^a		4,000

^a Facilities available to Mexico comprise regular and temporary short-term swaps between the Bank of Mexico and both the Federal Reserve and the ESF, as well as medium-term swaps and government guarantees between the Government of Mexico and the ESF. The total amount available from both medium-term swaps and government guarantees is \$20 billion, less any outstanding drawings on the short-term facilities.

Table 4

**DRAWINGS (+) AND REPAYMENTS (-) BY MEXICAN
MONETARY AUTHORITIES**

Millions of Dollars

	Outstanding as of December 31, 1994	January	February	March	Outstanding as of March 31, 1995
Reciprocal Currency Arrangements with the Federal Reserve					
Bank of Mexico (regular)	0.0	+500.0	+1,000.0	-500.0	1,000.0
Currency Arrangements with the U.S. Treasury Exchange Stabilization Fund					
Bank of Mexico (regular)	0.0	+500.0	+1,000.0	-500.0	1,000.0
Medium term	0.0	0.0	0.0	+3,000.0	3,000.0

Data are on a value-date basis.

TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

April–June 1995

During the second quarter of 1995, the dollar rose 0.6 percent against the German mark, but declined 2.1 percent against the Japanese yen, 1.9 percent against the Canadian dollar, and 0.3 percent on a trade-weighted basis.¹ The dollar, which had declined sharply during the first quarter of 1995 as expectations of higher U.S. interest rates subsided, remained under pressure through much of April. The dollar subsequently stabilized as diminished expectations of strong economic growth in Japan and Germany prompted market participants to consider the prospect for lower interest rates in these two countries and as market participants began to focus on a G-7 communique released in late April. By June, foreign exchange market activity had declined substantially as the dollar proceeded to settle into fairly narrow trading ranges despite increased volatility in U.S. interest rate markets. By the end of the second quarter, the dollar had risen 2.8 percent and 6.1 percent from its historic lows against the mark and the yen, respectively.

The U.S. monetary authorities intervened in the foreign exchange markets on three occasions during the period—April 3, April 5, and May 31—purchasing a total of \$3.6 billion against the German mark and the Japanese yen. On each occasion, the U.S. monetary authorities' purchases of dollars were divided evenly between the Federal Reserve System and the U.S. Treasury Department's Exchange Stabilization Fund (ESF). In other operations, the Mexican authorities drew a total of \$5 billion on their medium-term swap facility with the ESF. The Bank of Mexico also renewed its short-term swaps with the Federal Reserve and the ESF, each for \$1 billion, for an additional ninety days.

This report, presented by Peter R. Fisher, Executive Vice President, Federal Reserve Bank of New York, and Manager, System Open Market Account, describes the foreign exchange operations of the U.S. Department of the Treasury and the Federal Reserve System for the period from April 1995 through June 1995. Claudia Corra was primarily responsible for preparation of the report.

THE DOLLAR ENTERS THE QUARTER UNDER PRESSURE

Toward the end of the first quarter, the dollar continued to reach successive all-time lows against the yen and proceeded to close the quarter at ¥86.50 and DM 1.3735. Several factors weighing on the dollar at that time carried over into the second quarter. First, increasingly strong rhetoric from both sides surrounding the U.S.-Japan trade talks on autos and auto parts, as well as press reports that the United States was considering sanctions, appeared to herald a breakdown in the negotiations. Second, heavy dollar sales against yen by Japanese corporations and financial institutions continued in early April despite the April 1 start of the new Japanese fiscal year. Finally, market rumors of dollar sales by Asian central banks added pressure on the U.S. currency.

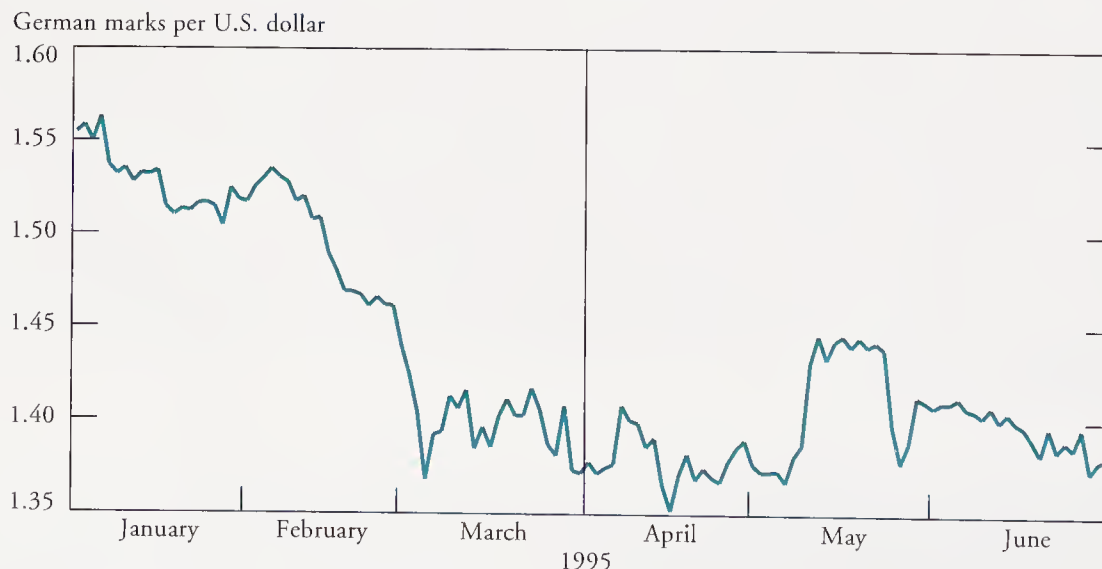
U.S. MONETARY AUTHORITIES PURCHASE DOLLARS AGAINST THE MARK AND THE YEN

On April 3, with the dollar trading at ¥86.50, the Federal Reserve Bank of New York's Foreign Exchange Desk entered the market in Asian trading on behalf of the U.S. monetary authorities, purchasing \$500 million against the yen from dealers in Tokyo, Singapore, Hong Kong, and Sydney. The dollar rallied briefly following the intervention, but gave up all of its gains by the New York open. Later that day, at about 11:20 a.m. in New York, the Desk entered the market again, buying \$750 million against the mark and \$250 million against the yen. The dollar-yen operation was coordinated with the Bank of Japan. Treasury Secretary Rubin confirmed the operation, stating, "This Administration believes a strong dollar is in America's interest, and we remain

Chart 1

THE DOLLAR AGAINST THE GERMAN MARK

Spot Exchange Rate



Source: Federal Reserve Bank of New York.

committed to strengthening the fundamentals that are ultimately important to maintaining a strong and stable currency.” Overall, the U.S. monetary authorities purchased \$1.5 billion during the course of the global trading day. However, the official purchases met sustained selling on any rally and the dollar ended the day slightly lower, at DM 1.3722 and ¥86.10.

On behalf of the U.S. monetary authorities, on April 5 the Desk again entered the market, at about 10:20 a.m., with the dollar trading at DM 1.3737 and ¥86.00. The Desk was joined in this operation by the Bundesbank and the Bank of Japan. Treasury Secretary Rubin confirmed the coordinated intervention, stating, “In effect, what you have is a shared commitment to a strong dollar, because it is in our interest and in the interests of the other economies of the world.” During the day, the U.S. monetary authorities purchased \$850 million against the mark and \$250 million against the yen. The dollar initially rallied on the intervention, reaching intraday highs of DM 1.3860 and ¥86.63, before drifting lower in thin afternoon markets to close essentially unchanged at DM 1.3720 and ¥86.01.

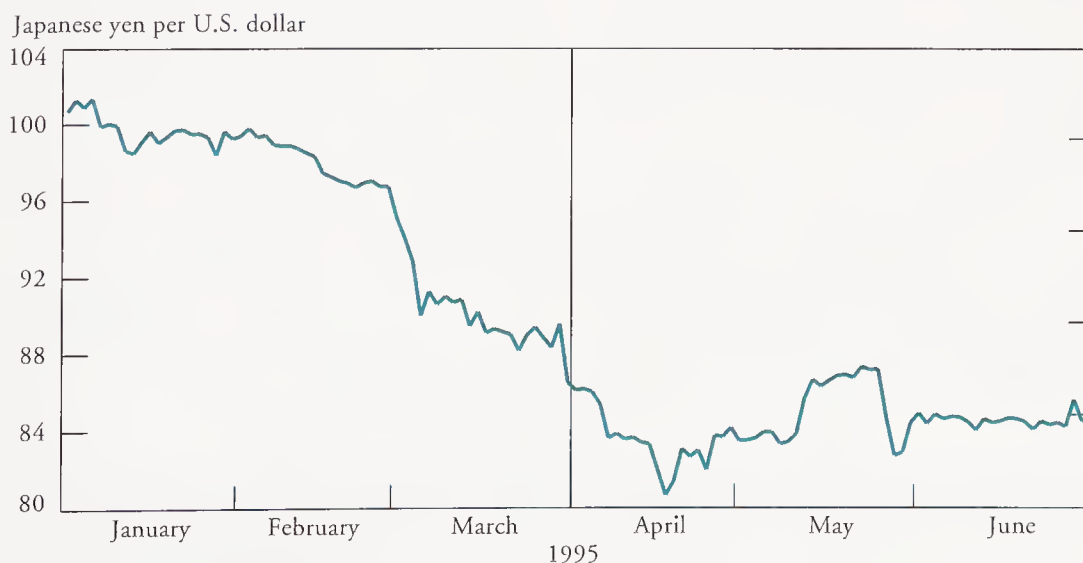
THE DOLLAR REACHES A NEW HISTORICAL LOW AGAINST THE YEN

Following these operations in early April, the dollar continued to decline against the yen. Increasingly, market participants viewed the sustained appreciation of the yen as a symptom of underlying structural problems in the Japanese economy. As a result, they began to focus their

Chart 2

THE DOLLAR AGAINST THE JAPANESE YEN

Spot Exchange Rate



Source: Federal Reserve Bank of New York.

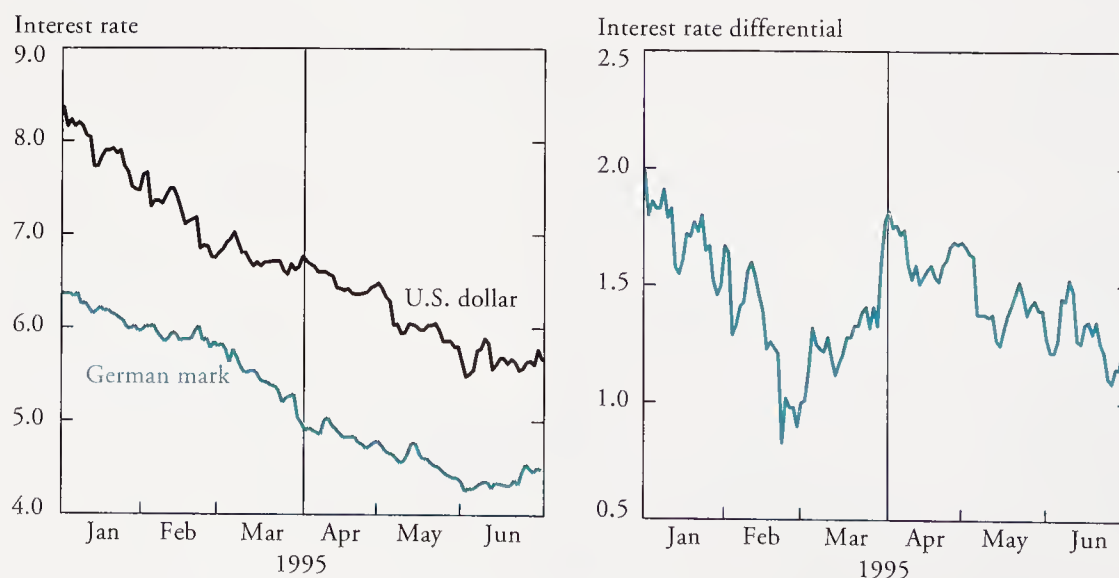
attention on the need for new monetary, fiscal, and deregulatory measures from the Japanese authorities to stimulate domestic demand and spur import growth. To help stem the yen's rise, the Japanese authorities unveiled an emergency economic plan on April 14. That day, the Bank of Japan also cut its official discount rate (ODR) by 75 basis points, to 1 percent. Despite the cut in interest rates, the dollar-yen exchange rate received little support from the package as many dealers viewed the fiscal and deregulatory measures as lacking in specifics. In addition, the absence of progress in the U.S.-Japan auto talks led U.S. officials to raise publicly the possibility of imposing trade sanctions against Japan, adding further downward pressure on the dollar. On Wednesday, April 19, the dollar reached a new low of ¥79.75.

That day, the dollar also reached a period low of DM 1.3472 against the mark—close to the historical low of DM 1.3438 reached on March 8, 1995. Other factors weighing on the dollar-mark exchange rate included heightened political concerns ahead of the first round of the French presidential election and regional elections in Italy, both scheduled for April 23, which led to renewed appreciation of the mark within Europe. Moreover, in the United States, expectations unwound for any further monetary tightening as a series of weaker-than-expected U.S. economic data releases—particularly declines in retail sales, industrial production, and housing starts—appeared to signal a clear slowdown in the pace of U.S. economic growth.

Chart 3

DIFFERENTIAL BETWEEN DOLLAR AND GERMAN MARK SHORT-TERM INTEREST RATES

Implied by the Three-Month Eurodeposit Futures (September 1995 Contracts)



Source: Bloomberg L.P.

THE DOLLAR BEGINS TO STABILIZE

The dollar began to stabilize against both the mark and the yen in late April and early May. First, the overhang of long-dollar positions against the yen, evident at the start of the period, apparently began to dissipate. Second, anticipation of the April 25 meeting of G-7 finance ministers and central bank governors helped lift the dollar off its lows as dealers began to speculate about the possibility of a coordinated policy response to dollar weakness. Subsequent to the meeting, the G-7 finance ministers and central bank governors released a statement that included the following:

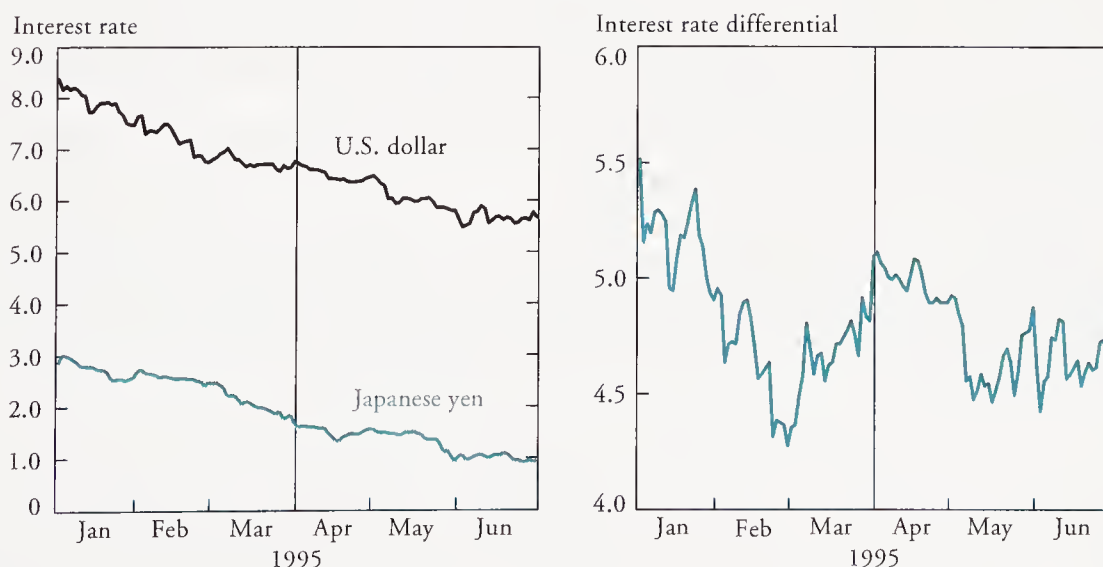
The Ministers and Governors expressed concern about recent developments in exchange markets. They agreed that recent movements have gone beyond the levels justified by underlying economic conditions in the major countries. They also agreed that orderly reversal of those movements is desirable, would provide a better basis for a continued expansion of international trade and investment, and would contribute to our common objectives of sustained non-inflationary growth. They further agreed to strengthen their efforts in reducing internal and external imbalances and to continue to cooperate closely in exchange markets.

By the end of April, the dollar reached DM 1.3855 and ¥84.15.

Chart 4

DIFFERENTIAL BETWEEN DOLLAR AND JAPANESE YEN SHORT-TERM INTEREST RATES

Implied by the Three-Month Eurodeposit Futures (September 1995 Contracts)



Source: Bloomberg L.P.

In early May, international investors began to unwind their long German mark positions established during the first quarter, when exchange rate volatility had created a rush toward mark-denominated assets. First, investors began to increase their exposure to the higher yielding European markets, particularly after pre-election uncertainties in Italy and France receded, and these flows helped weaken the mark within Europe. Second, portfolio managers, many of whom were underweight U.S. assets, began to underperform their benchmarks when the U.S. bond market rally accelerated. As these investors in turn increased their exposure to the U.S. market, the dollar moved further off its lows.

Buoyed by these flows, the dollar remained steady despite further signs of weakness in the U.S. economy, particularly the April nonfarm payroll report, and associated speculation that the Federal Reserve might need to lower interest rates. Similarly, the dollar had little reaction to the May 10 announcement that, due to a breakdown in U.S.-Japan trade talks on autos and auto parts, the U.S. would initiate sanctions against Japan. The dollar's ability to trade through these ostensibly negative developments suggested to some market participants that, by early May, the dollar's recent problems had become fairly well discounted.

THE DOLLAR RALLIES SUDDENLY

On May 11 and May 12, several factors came together to propel the dollar higher. Early in the morning on May 11, the U.S. House Budget Committee approved a series of deficit reduction measures, causing some shortcovering on increased optimism over the U.S. fiscal outlook. During the European trading session, holders of short-dollar positions were further unnerved by market reports of dollar buying by some large Asian accounts. These factors helped lift the dollar through the technical resistance level of DM 1.3920, bringing the dollar to DM 1.4120 by the time the New York market opened. Later that morning, Bundesbank President Tietmeyer said that both Germany and its partner economies would suffer if the mark remained overvalued and added that, "We are not . . . interested in a sustained currency overvaluation." The dollar subsequently broke through the long-standing technical resistance level of DM 1.4225, causing the dollar to spike higher as dealers scrambled to cover substantial short-dollar positions. Over the two-day period, the dollar rose six pfennigs, to DM 1.4465, and three yen, to ¥86.65. Buoyed by the dollar's sharp rise, sentiment toward the U.S. currency turned quickly positive, a shift that encouraged some fresh dollar buying. On May 18 and May 22, the dollar reached intraquarter highs of DM 1.4618 and ¥87.72, respectively.

However, a lack of follow-through buying disappointed some market participants. The dollar was also adversely affected by weaker-than-expected U.S. durable goods data and existing home sales data, which prompted market participants to speculate on a possible interest rate ease by

autumn. With market liquidity reduced due to holidays in Europe, the dollar fell sharply on May 25 and May 26, reaching DM 1.3740 and ¥82.45.

G-10 COUNTRIES INTERVENE TO SUPPORT THE DOLLAR

On the morning of Wednesday, May 31, with the dollar trading at DM 1.3850 and ¥82.70, the Desk entered the market in concert with the central banks of the other G-10 countries, purchasing dollars against marks and yen in an operation initiated by the U.S. monetary authorities. The U.S. monetary authorities' purchases totaled \$500 million against the mark and \$500 million against the yen.

The operation took the market by surprise, triggering a shortcovering rally. Treasury Secretary Rubin confirmed the intervention as consistent with objectives expressed in the April 25 G-7 communique. Market participants interpreted the operation as a signal of increased coordination by the major central banks and a reflection of their mutual desire for a stronger dollar. The dollar closed the day at DM 1.4135 and ¥84.40.

THE DOLLAR TRADES IN NARROW RANGES AGAINST THE MARK AND THE YEN DURING MOST OF JUNE

During June, the dollar settled in narrow trading ranges of DM 1.3880 to DM 1.4200 and ¥84.00 to ¥85.50. Dealers became increasingly reluctant to take risk, in part due to May's volatile dollar moves but also due to fears of further coordinated intervention ahead of the G-7 summit, held in Halifax, Canada, June 15-17. While the G-7 Halifax communique offered no new initiatives on the dollar, it endorsed the April statement of the G-7 finance ministers and central bank governors, which called for an "orderly reversal" of the dollar's decline.

Increased uncertainty over the near-term outlook for interest rate differentials with Germany and Japan also kept the dollar pinned in narrow trading ranges. The surprisingly weak May nonfarm payroll number released on June 2 reinforced market perceptions of slower U.S. economic growth and increased market participants' expectations of an ease in U.S. monetary policy. At the same time, market participants also began to focus on the prospects for rate cuts in Germany and Japan.

In Germany, weak industrial production data for February and M3 data for the first quarter introduced the idea of a possible Bundesbank ease before the Bundesbank council's mid-summer recess. In Japan, continued signs of stagnant demand and growing concerns over the health of Japan's banking system prompted fears that Japan would slip back into recession.

Throughout June, market participants increasingly took the view that the United States would impose trade sanctions on Japan on June 28, as announced in early May. Despite this possibility, the dollar-yen exchange rate traded with a steady tone, in part because market participants were unable to reach a consensus on the ultimate impact of sanctions. Some viewed the likely imposition of sanctions as negative for the dollar, while others held the opposite view, expecting that sanctions would effect a faster reduction in the Japanese trade surplus. The dollar briefly rallied following the June 28 agreement between the United States and Japan on autos and auto parts, but soon gave up its gains as dealers came to view the commitments involved as insufficient to reduce materially Japan's trade surplus. The dollar closed the quarter at DM 1.3812 and ¥84.65.

MEXICAN FINANCIAL MARKETS FIND A RANGE OF STABILITY

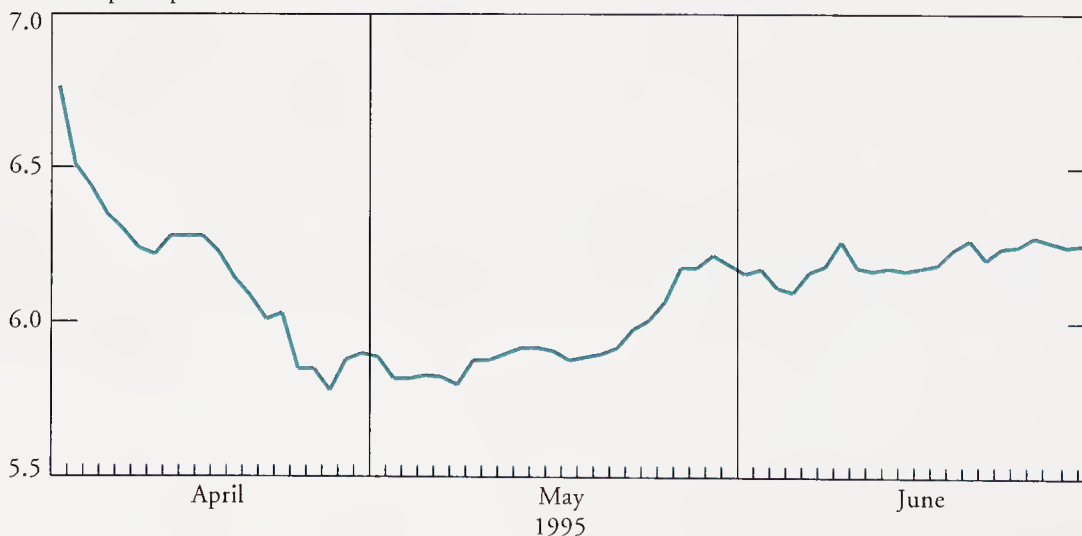
Over the period, Mexican financial markets recovered substantially as the economy began to show the effects of tough monetary and fiscal policies, and as some foreign investors cautiously returned to the Mexican markets. The Mexican peso steadied for the first time since the December 1994 devaluation, appreciating approximately 7.5 percent against the dollar during the quarter. Mexico's IPC stock market index recovered as well, rising 19.8 percent in local currency terms. Nominal interest rates fell dramatically, reflecting diminished inflation expectations. Mexico's inflation rate peaked in April and then started to decline, prompting most market analysts to anticipate further declines later this year.

Chart 5

THE DOLLAR AGAINST THE MEXICAN PESO

Spot Exchange Rate

Mexican pesos per U.S. dollar



Source: Federal Reserve Bank of New York.

MEXICAN SWAP ACTIVITY

The Mexican authorities drew \$3 billion on April 19 and \$2 billion on May 19 on their medium-term facility with the ESF, bringing the total amount drawn by Mexico under the Medium-Term Stabilization Agreement to \$8 billion. In addition, on May 3, the Bank of Mexico renewed its short-term swaps with the ESF and the Federal Reserve System for an additional ninety days, each for \$1 billion.

CANADIAN MONETARY POLICY EASES

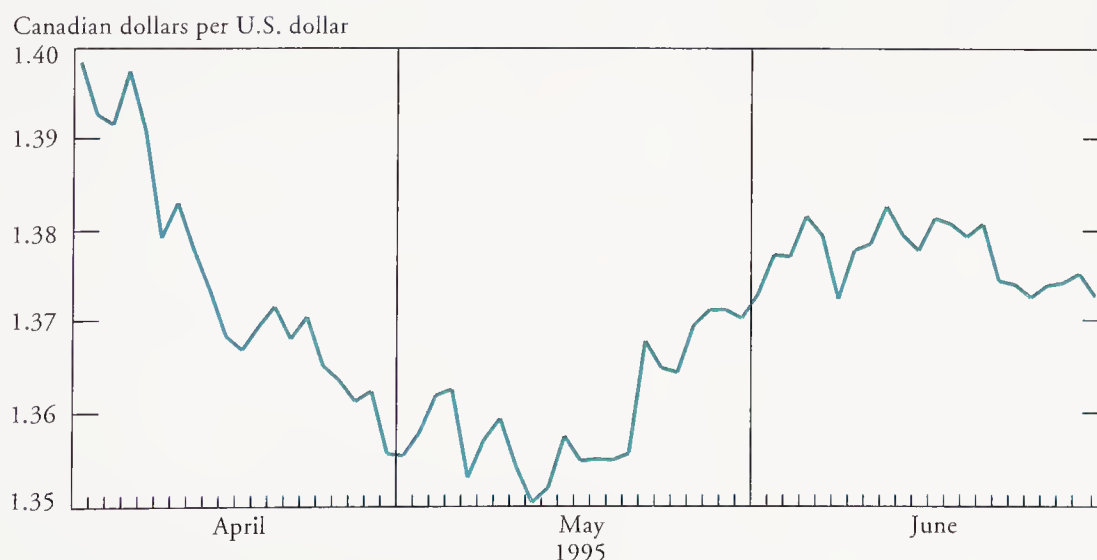
Canadian financial markets performed positively over the period as concerns over the federal budget deficit and fears of Quebec independence receded. The April 12 decision by Moody's to downgrade the federal government's foreign currency debt to Aa2 from Aa1, and its domestic debt to Aa1 from Aaa, was largely anticipated and had little market impact. The Canadian dollar, having opened the quarter at C\$1.3990, reached a period high of C\$1.3475 on May 15.

On May 8, the Bank of Canada began to ease monetary policy following a succession of weaker-than-expected Canadian economic data releases. Over the period, the call money target range declined a cumulative 75 basis points, to 7.00-7.50 percent. Initially pressured by the easier monetary policy stance, the Canadian dollar withstood the successive declines in interest rates and proceeded to consolidate in a range of C\$1.3720-C\$1.3820.

Chart 6

THE U.S. DOLLAR AGAINST THE CANADIAN DOLLAR

Spot Exchange Rate



Source: Federal Reserve Bank of New York.

TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE RESERVES

The U.S. monetary authorities intervened three times during the period, buying a total of \$1.5 billion against yen and \$2.1 billion against marks. On all three occasions, intervention operations were divided evenly by the Federal Reserve System and the ESF.

At the end of the period, the current values of the foreign exchange reserve holdings of the Federal Reserve System and the ESF were \$24 billion and \$29.1 billion, respectively. The U.S. monetary authorities regularly invest their foreign currency balances in a variety of instruments that yield market-related rates of return and have a high degree of liquidity and credit quality. A portion of the balances is invested in foreign-government-issued securities. As of June 30, the Federal Reserve System and the ESF held, either directly or under repurchase agreement, \$9.8 billion and \$13.5 billion, respectively, in foreign-government securities.

ENDNOTE

1. The dollar's movements on a trade-weighted basis against ten major currencies are measured using an index developed by staff at the Board of Governors of the Federal Reserve System.

Table 1
**FOREIGN CURRENCY HOLDINGS OF U.S. MONETARY
AUTHORITIES, BASED ON CURRENT EXCHANGE RATES**
Millions of Dollars

	Balances as of March 31, 1995	Quarterly Changes in Balances by Source				Balances as of June 30, 1995
		Net Purchases and Sales ^a	Impact of Sales ^b	Investment Income	Currency Valuation Adjustments ^c	
Federal Reserve						
Deutsche marks	14,877.3	(1,050.0)	(0.1)	163.4	(54.6)	13,936.0
Japanese yen	9,416.9	(750.0)	1.1	45.5	217.9	8,931.4
Mexican pesos ^d	865.1	(14.3)	0.0	14.3	102.4 ^e	967.5
Subtotal	25,159.2	(1,814.3)	1.0	223.2	265.7	23,834.8
Interest receivables ^f	127.3					126.0
Total	25,286.5					23,960.8
U.S. Treasury						
Exchange Stabilization Fund						
Deutsche marks	8,148.8	(1,050.0)	(0.1)	85.6	(31.1)	7,153.2
Japanese yen	13,196.3	(750.0)	1.1	85.9	310.5	12,843.9
Mexican pesos ^d	4,000.0	4,842.0	0.0	158.0	0.0 ^e	9,000.0
Subtotal	25,345.2	3,042.0	1.0	329.5	279.4	28,997.1
Interest receivables ^f	88.0					72.8
Total	25,433.2					29,069.9

Note: Figures might not sum because of rounding.

^a Purchases and sales for the purpose of this table include foreign currency sales and purchases related to official activity, swap drawings and repayments, and warehousing.

^b This number is calculated using marked-to-market exchange rates; it represents the difference between the sale exchange rate and the most recent revaluation exchange rate. Realized profits and losses on sales of foreign currencies, computed using the difference between the historic cost-of-acquisition exchange rate and the sale exchange rate, are reflected in Table 2.

^c Foreign currency balances are marked-to-market monthly at month-end exchange rates.

^d See Table 4 for a breakdown of Mexican swap activities. Note that the investment income on Mexican swaps is sold back to the Bank of Mexico.

^e Valuation adjustments on peso balances do not affect profit and loss because the impact is offset by the unwinding of the forward contract at the repayment date. Note that the ESF does not mark-to-market its peso holdings, but the Federal Reserve System does. However, Mexico is obligated to maintain in dollar terms the value of ESF peso holdings resulting from Mexican drawings under the Medium-Term Stabilization Agreement.

^f Interest receivables for the ESF are revalued at month-end exchange rates. Interest receivables for the Federal Reserve System are carried at cost and are not marked-to-market until interest is paid.

Table 2

**NET PROFITS (+) OR LOSSES (-) ON U.S. TREASURY AND
FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS, BASED ON
HISTORIC COST-OF-ACQUISITION EXCHANGE RATES**

Millions of Dollars

	Federal Reserve	U.S. Treasury Exchange Stabilization Fund
Valuation profits and losses on outstanding assets and liabilities as of March 31, 1995		
Deutsche marks	3,747.2	1,569.8
Japanese yen	3,520.5	4,939.9
Total	7,267.7	6,509.8
Realized profits and losses from foreign currency sales ^a		
March 31, 1995 - June 30, 1995		
Deutsche marks	259.0	196.6
Japanese yen	284.7	285.1
Total	543.7	481.7
Valuation profits and losses on outstanding assets and liabilities as of June 30, 1995 ^b		
Deutsche marks	3,433.5	1,342.0
Japanese yen	3,454.8	4,966.4
Total	6,888.3	6,308.5

Note: Figures might not sum because of rounding.

^a As indicated in Table 1, foreign currency sales totaled \$2,100.0 million against Deutsche marks and \$1,500.0 million against Japanese yen.

^b Valuation profits or losses are not affected by peso holdings, which are canceled by forward contracts.

Table 3

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

<u>Institution</u>	<u>Amount of Facility</u>	<u>Outstanding as of June 30, 1995</u>
Austrian National Bank	250	0
National Bank of Belgium	1,000	0
Bank of Canada	2,000	0
National Bank of Denmark	250	0
Bank of England	3,000	0
Bank of France	2,000	0
Deutsche Bundesbank	6,000	0
Bank of Italy	3,000	0
Bank of Japan	5,000	0
Bank of Mexico ^a		
Regular swaps	3,000	1,000
Temporary swaps	3,000	0
Netherlands Bank	500	0
Bank of Norway	250	0
Bank of Sweden	300	0
Swiss National Bank	4,000	0
Bank for International Settlements		
Dollars against Swiss francs	600	0
Dollars against other authorized European currencies	1,250	0
Total	35,400	1,000

**U.S. TREASURY EXCHANGE STABILIZATION FUND
CURRENCY ARRANGEMENTS**

Millions of Dollars

<u>Institution</u>	<u>Amount of Facility</u>	<u>Outstanding as of June 30, 1995</u>
Deutsche Bundesbank	1,000	0
Bank of Mexico ^a		
Regular swaps	3,000	1,000
United Mexican States ^a		
Medium-term swaps		8,000
Total ^a		9,000

^a Facilities available to Mexico comprise regular and temporary short-term swaps between the Bank of Mexico and both the Federal Reserve and the ESF, as well as medium-term swaps and government guarantees between the Government of Mexico and the ESF. The total amount available from both medium-term swaps and government guarantees is \$20 billion, less any outstanding drawings on the short-term facilities.

Table 4

**DRAWINGS (+) AND REPAYMENTS (-) BY MEXICAN
MONETARY AUTHORITIES**

Millions of Dollars

	Outstanding as of March 31, 1995	April	May	June	Outstanding as of June 30, 1995
Reciprocal Currency Arrangements with the Federal Reserve					
Bank of Mexico (regular)	1,000.0	0.0	+1,000.0 ^a -1,000.0 ^a	0.0	1,000.0
Currency Arrangements with the U.S. Treasury Exchange Stabilization Fund					
Bank of Mexico (regular)	1,000.0	0.0	+1,000.0 ^a -1,000.0 ^a	0.0	1,000.0
Medium-term	3,000.0	+3,000.0	+2,000.0	0.0	8,000.0

Note: Data are on a value-date basis.

^a Drawing of February 2 was renewed on May 3 for an additional ninety days.

TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

July–September 1995

During the third quarter of 1995, the dollar rose 17.6 percent against the Japanese yen, 3.3 percent against the German mark, 2.1 percent against the Mexican peso, and 3.2 percent on a trade-weighted basis¹ against other G-10 currencies, but fell 2.3 percent against the Canadian dollar. The dollar's appreciation reflected relative changes in market participants' expectations of economic performance and of the associated monetary policy reactions of Japan, Germany, and the United States. Exchange market cooperation among the monetary authorities also contributed to the dollar's upward trend.

The U.S. monetary authorities intervened in the foreign exchange markets on three occasions during the quarter—July 7, August 2, and August 15—purchasing a total of \$1.533 billion against the German mark and the Japanese yen. On each occasion, the U.S. monetary authorities' purchases of dollars were divided evenly between the Federal Reserve System and the U.S. Treasury Department's Exchange Stabilization Fund (ESF). In other operations, Mexico drew a total of \$2.5 billion on its medium-term swap facility with the ESF. The ESF and the Federal Reserve also renewed short-term swap facilities for Mexico, each in the amount of \$1 billion, for an additional 90 days.

CHANGING GLOBAL ECONOMIC OUTLOOK

While the dollar had previously risen from the historic lows against the yen and the mark recorded in March and April, many market participants still perceived the dollar as undervalued as the

This report, presented by Peter R. Fisher, Executive Vice President, Federal Reserve Bank of New York, and Manager, System Open Market Account, describes the foreign exchange operations of the U.S. Department of the Treasury and the Federal Reserve System for the period from July 1995 through September 1995. Soo J. Shin was primarily responsible for preparation of the report.

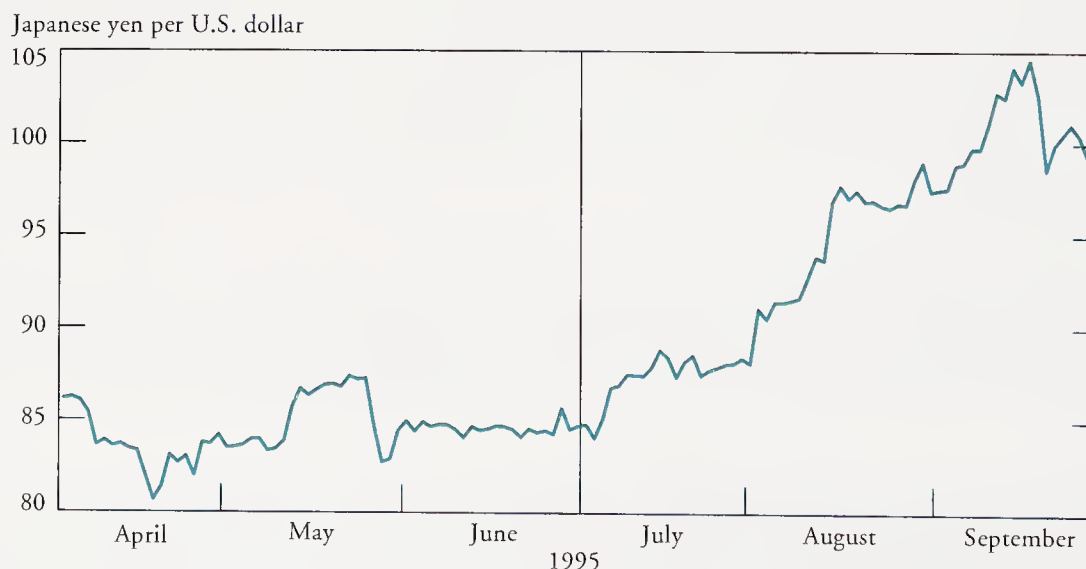
third quarter began but remained unsure of factors or conditions that might prompt a sustained upward trend in the dollar's value. Moreover, as suggested by implied yields on interest rate futures contracts, market participants had come to expect that the Federal Reserve would ease the Federal Funds rate by as much as 50 basis points by year-end and that the Bank of Japan might ease call rates again, but by a smaller increment of roughly 25 basis points. Meanwhile, market participants held disparate views on the outlook for Bundesbank monetary policy, with some expecting an interest rate easing while others expected no change. Expectations among market participants reflected concerns that the U.S. economy might slip into recession, that the Japanese economy was unlikely to react to further monetary easing, and that the German economy was expected to grow moderately.

Beginning in July, however, soon after the Federal Reserve's widely anticipated reduction in the Federal Funds rate by 25 basis points, different expectations about the three major industrial economies began to emerge. In Japan, monetary, fiscal, and regulatory actions undertaken by the Japanese authorities increased confidence among market participants that the authorities were prepared to address actively the economy's weakness. The perception of softness in the German economy became more pronounced. In the United States, however, fears of a material economic slowdown abated as the likelihood of achieving steady growth increased while hints of an economic

Chart 1

THE DOLLAR AGAINST THE JAPANESE YEN

Spot Exchange Rate



Source: Federal Reserve Bank of New York.

rebound emerged later in the quarter. Supported by these developments, the dollar rose 15.4 percent against the Japanese yen and 7.0 percent against the German mark by mid-August to reach ¥97.65 and DM 1.4775, respectively. From the historical lows of ¥79.75 and DM 1.3438 reached on April 19 and March 8, respectively, the dollar had risen 22.4 percent against the Japanese yen and 9.9 percent against the German mark.

Beginning in mid-August, the mark's downward trend halted while the yen continued to depreciate against most other currencies. Then, in late September, the mark appreciated sharply against most other European currencies as concerns grew about Europe's political and fiscal prospects and the achievability of European monetary union (EMU) as scheduled. Doubts about France and Italy, in particular, prompted a general flight to German marks from French francs, Italian lira, and other European currencies where high unemployment and concerns about fiscal consolidation persisted.

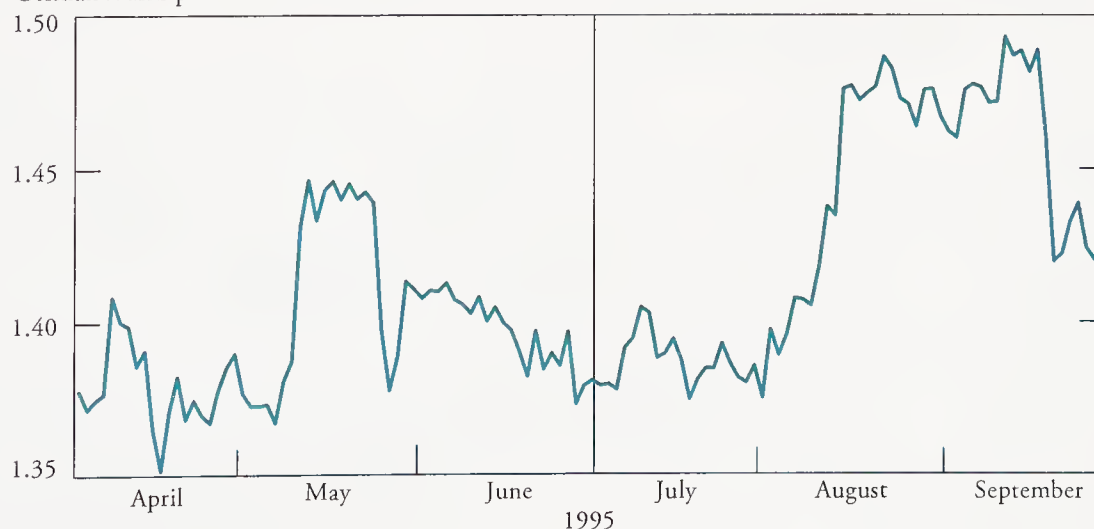
This sharp rise in the mark affected the dollar negatively. Having reached a 15-month high of ¥104.68 and a seven-month high of DM 1.5045 by mid-September, the dollar gave up some of its gains in the third week of September as a combination of events initiated a bout of profit-taking on long-dollar positions. The dollar consolidated at the end of the month, however, and closed the quarter at ¥99.55 and DM 1.4273.

Chart 2

THE DOLLAR AGAINST THE GERMAN MARK

Spot Exchange Rate

German marks per U.S. dollar



Source: Federal Reserve Bank of New York.

JAPANESE POLICY MEASURES CONTRIBUTE TO THE DOLLAR'S RALLY

At the start of the quarter, market participants remained wary of further risks of deflation in Japan, associated deterioration in the Japanese financial system, and persistent, large trade and current account surpluses. Without immediately apparent remedies for these problems, market participants anticipated a renewed ascent in the Japanese yen.

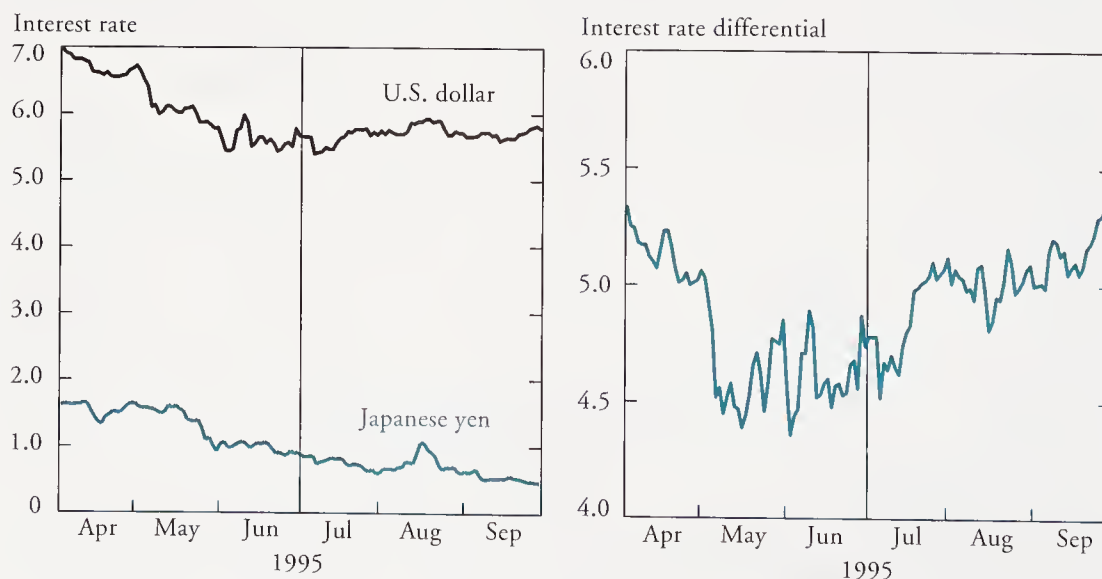
Several policy actions taken by the Japanese authorities in July and August, however, prompted a shift in expectations. These were perceived as enhancing the prospects for Japan's economic recovery and sparked a sharp rally in the dollar against the yen. On July 7, the Bank of Japan guided the overnight call money rate to a historic low of 0.75 percent, below the official discount rate (ODR). Market participants immediately began to anticipate a near-term reduction in the ODR, which would further reduce Japanese interest rates and weaken the yen.

On August 2, the Ministry of Finance announced a series of deregulatory measures aimed at encouraging Japanese investment abroad, including changes that would allow Japanese financial institutions to participate fully in longer-maturity, non-yen denominated loan facilities. The measures were well-received by market participants as deliberate steps to weaken the yen and address domestic deflationary pressures. While a surge in Japanese purchases of overseas assets was not

Chart 3

DIFFERENTIAL BETWEEN DOLLAR AND JAPANESE YEN SHORT-TERM INTEREST RATES

Implied by the Three-Month Eurodeposit Futures (December 1995 Contracts)



Source: Bloomberg L.P.

observed immediately after the announcement of the deregulatory package, market participants noted broad-based sales of yen against a variety of currencies and unwinding of currency hedges by Japanese investors on their existing foreign assets. On August 15, following the release of a lower than expected Japanese trade surplus, the dollar rose above ¥94.50 in Tokyo trading; for technical traders, the breach of this important level signified a change in the dollar's five-year downward trend against the yen.

In addition, confidence in Japan's resolve to deal with the problem of nonperforming loans and a weak financial sector increased following the authorities' swift response to the failure of three Japanese financial institutions. The closure of Cosmo Credit Corporation, Japan's fifth largest credit union, was announced on July 31. Subsequently, on August 30, the Japanese authorities announced the failures of Hyogo Bank and Kizu Shinyo Kumiai ("Kizu") credit union, Japan's largest second-tier regional bank and largest credit union, respectively. On August 28, the resolution of the Cosmo case was announced jointly by the Ministry of Finance and Tokyo metropolitan authorities. This was followed promptly by Bank of Japan Governor Matsushita's August 30 announcement of the plan to reconstruct Hyogo bank and the Osaka Prefecture's decision to suspend Kizu's operations. On August 30, the dollar surged to a seven-month high of ¥99.40 as anticipation began to mount that the Japanese authorities would announce broad-based measures to strengthen the banking system.

Over the subsequent three weeks, the yen continued to depreciate, particularly after the Bank of Japan lowered the ODR on September 8 by 50 basis points to 0.50 percent and guided the call money rate below the ODR. Increasingly, market participants turned their attention toward the economic stimulus package scheduled to be unveiled on September 20. In the run-up to the package the dollar rose to ¥104.68, as market participants anticipated another clear effort by the Japanese authorities to weaken the yen.

THE GERMAN ECONOMY APPEARS TO SLOW WHILE U.S. ECONOMY SHOWS SIGNS OF QUICKENING ACTIVITY

At the start of the quarter, market participants generally expected German economic growth to remain moderate, prices to stabilize, and official interest rates to remain unchanged. Over the course of July and August, however, expectations of German economic growth shifted perceptibly lower. The lack of reliable official data, as government agencies were in the process of recalibrating several key statistics, caused some confusion among market participants. Available data and surveys of the industrial sectors suggested low inflation and weak current activity, which, coupled with weak M3 money supply growth, contributed to lower economic growth forecasts and increased expectations for monetary easing in Germany. Indeed, on August 9, the Bundesbank

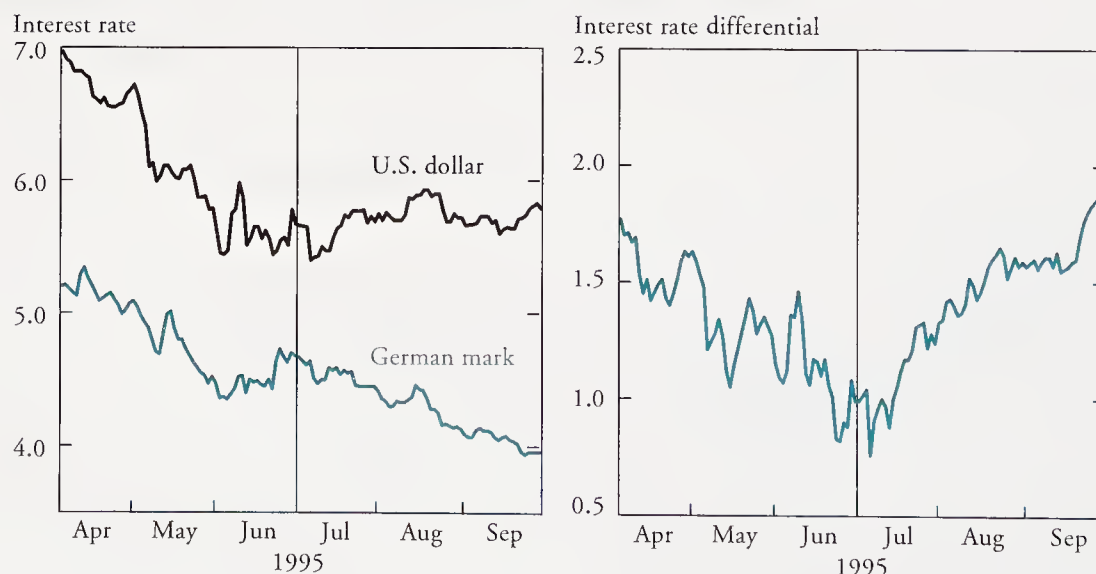
guided the repo rate lower by five basis points to 4.45 percent. This was the first appreciable cut since early April 1995, and it gave rise to expectations that the Bundesbank had begun a process of gradual monetary easing. As anticipated, the Bundesbank lowered the repo rate six more times in the following weeks, bringing the cumulative repo rate reductions during the quarter to 42 basis points to arrive at 4.08 percent. In addition, on August 24, the Bundesbank reduced both its discount and Lombard rates by 50 basis points to 3.5 and 5.5 percent, respectively. Following the reduction in official German interest rates, the dollar rose as high as DM 1.4990 in late August.

As perceptions of a slowing German economy became increasingly widespread, the notion that the U.S. growth rate may have hit a trough became more prevalent in August. Within a few days after the U.S. monetary easing on July 6 market participants substantially scaled back their expectations for further easing, as reflected in the rise in implied yields on interest rate futures contracts. Implied yields moved gradually upward throughout July and most of August following a series of stronger than expected data releases, particularly June nonfarm employment, June retail sales, and second quarter GDP growth, all of which were released in July. These releases were followed by the Philadelphia Fed diffusion index in late September, which similarly pointed to better than expected economic conditions in the United States.

Chart 4

DIFFERENTIAL BETWEEN DOLLAR AND GERMAN MARK SHORT-TERM INTEREST RATES

Implied by the Three-Month Eurodeposit Futures (December 1995 Contracts)



Source: Bloomberg L.P.

Notwithstanding the diverging economic outlooks for Germany and the United States, foreign exchange market participants appeared to lack sufficient confidence in forecasts that called for improving U.S. economic activity and slowing German economic growth. In July, the dollar moved only slightly higher against the mark, hovering near DM 1.3900. While the dollar appreciated against the German mark in the first two weeks of August, its move upward appeared to follow in sympathy with the dollar's move against the yen rather than to reflect the shifting U.S. and German economic outlooks.

THE U.S. MONETARY AUTHORITIES INTERVENE ON THREE OCCASIONS

The first intervention operation of the quarter was undertaken on July 7 after the dollar reached a high of ¥86.20 following the July 7 monetary easing by the Japanese authorities. The Federal Reserve Bank of New York's Foreign Exchange Desk entered the New York market on behalf of the U.S. monetary authorities, purchasing \$333.3 million against the yen. This operation was coordinated with the Japanese monetary authorities. The dollar reached a high of ¥87.15 after the intervention before closing the New York trading session at ¥86.70.

On August 2, the Desk again entered the New York market after the dollar had risen to ¥90.15 following the announcement of Japanese measures to promote overseas investment and loans. The Desk purchased \$500 million against the yen on behalf of the U.S. monetary authorities. This operation was also coordinated with the Japanese monetary authorities. The dollar strengthened following the intervention, closing the New York trading session at ¥90.99, near the day's high.

On both occasions, the U.S. Treasury confirmed the operation. As the intervention began on August 2, Treasury Secretary Rubin issued the following statement:

“We welcome the actions taken by the Japanese authorities to remove impediments to capital movements. These actions and our joint operations are consistent with the April 25 G-7 communiqué.”

In the subsequent weeks, shifting economic expectations combined with the concerted official intervention contributed to the dollar's appreciation against the yen. In addition, natural buyers of dollars, who had in previous months lagged their purchase requirements in anticipation of more advantageous levels, hastened to buy as the dollar rose. At the same time, natural sellers of dollars, including Japanese exporters, stayed on the sidelines in the first weeks of August thereby allowing the dollar to rise. Many natural sellers, motivated by their concerns about the future depreciation in the dollar, had accelerated their selling efforts in the earlier months and had already largely fulfilled their then-current selling needs.

The third operation, on August 15, was coordinated with the Japanese monetary authorities and the Bundesbank. The Desk entered the markets in London, Frankfurt, and New York, purchasing \$300 million against the Japanese yen and \$400 million against the German mark. The dollar was trading near ¥95.02 and DM 1.4476 as the operation began. Following the intervention, the dollar rose to highs of ¥96.98 and DM 1.4795 before declining modestly to close at 96.81 and DM 1.4765. In the next few days, market participants gained confidence in the view that the U.S. Administration supported a stronger dollar not only against the yen but against other currencies as well.

MARKET REEXAMINES EUROPEAN POLITICAL AND FISCAL PROSPECTS

In July and August, the French franc, the Italian lira, and other major European currencies strengthened against the mark, benefiting from a combination of factors, including expectations of gradual monetary easing in Germany, continued investment shifts into higher yielding markets, greater seasonal tourism flows into southern European countries, and modest optimism of fiscal tightening in most European countries. By mid-August, the French franc and Italian lira strengthened against the German mark, reaching a 13-month high of FRF 3.4014 and a 6-month high of ITL 1084.70, respectively. Against the background of continuing positive performance in high-yielding markets and positive comments from local government officials, market participants gained greater confidence that fiscal deficits in several European countries would improve sufficiently to meet the targets established for EMU.

In late August, however, major European currencies' upward momentum against the German mark began to dissipate as concerns surrounding the process of EMU began to reemerge. The unexpected resignation on August 25 of French Finance Minister Madelin cast doubts on the prospects of fiscal contraction in Europe, particularly following reports that Madelin had been forced to resign because of his support for aggressive public spending cuts. In this context, the German mark appreciated against other European currencies from mid-August to mid-September, and in turn, as the mark strengthened, the dollar's upward trend began to encounter some resistance.

DOLLAR RETRACES ITS GAINS LATE IN THE PERIOD

Toward the end of the quarter, the dollar retraced some of its earlier gains as a confluence of events in Japan, Europe, and the United States triggered dollar selling. Early on September 20, following the release of Japan's much-awaited economic stimulus package, the dollar came under pressure against the yen. In the days prior to the release of the package, comments from Japanese government officials led to heightened expectations of a significant stimulus package that would help revive the Japanese economy. Some market participants even began to speculate that the package would encompass not only fiscal measures but also significant regulatory changes and financial

sector support, despite prior indications from Japanese officials that the package would not include such measures. Although the ¥14.2 trillion package was somewhat larger than originally anticipated, the measures were generally as expected and did not include any new deregulatory or banking initiatives. In the event, speculative players began to unwind their long-dollar and short-yen positions that were established in anticipation of the release of the stimulus package.

Also on September 20, European financial markets came under sharp selling pressure after reports of comments by several German officials sparked intensified skepticism about the viability of EMU. German Finance Minister Waigel reportedly stated that Italy was unlikely to qualify for the initial group of states forming a single currency. In addition, news reports indicated that Bundesbank Council member Jochimsen had emphasized the importance of member states' adhering strictly to the Maastricht Treaty and suggested that France and Belgium might not meet EMU entry criteria. Earlier on the same day, the official presentation of France's 1996 budget had elicited little initial reaction among market participants, though some analysts voiced skepticism about the budget's targets; following reports of the German officials' comments, however, skepticism escalated concerning the fiscal situations in various European countries. Nervousness among market participants increased as they began to focus more closely on the forthcoming presentation of Italy's 1996 budget. During the week of September 18, the German mark rose by 4.6 percent against the lira, to ITL 1130.73, and 0.7 percent against the French franc, to FRF 3.4645. This upward pressure on the mark within Europe placed downward pressure on the dollar in the subsequent days.

The dollar's decline was aided by the September 20 release of worse than expected July U.S. trade data, which disappointed some market participants who had been hoping for evidence of an improvement in the U.S. trade and current account balances. In the background, some market participants noted growing concern about the debate between the Administration and the Congress regarding the budget process and debt limit extension, which triggered some concerns of possible disruptions to the upcoming Treasury auctions.

Between September 20 and 22, the combination of events outlined above prompted severe selling pressure on the dollar. The dollar fell by 4.7 percent against the German mark and 4.4 percent against the Japanese yen to close at DM 1.4225 and ¥99.90, respectively, on September 22. Market participants, many of whom had reportedly established long positions in European currencies and short positions in the German mark during the summer, began to sell European currencies against the mark. The effect on the dollar was accentuated by investors' sales of dollars for marks as a proxy for the less liquid cross exchange rates between the European currencies and the German mark.

DOLLAR STABILIZES IN A NARROW RANGE

In the final week of September after the adjustment of long-dollar positions had tapered off, the dollar recovered partially and consolidated in trading ranges of DM 1.42 to DM 1.44 and ¥99 to ¥101. The dollar closed the quarter at ¥99.55 and DM 1.4273.

CANADA

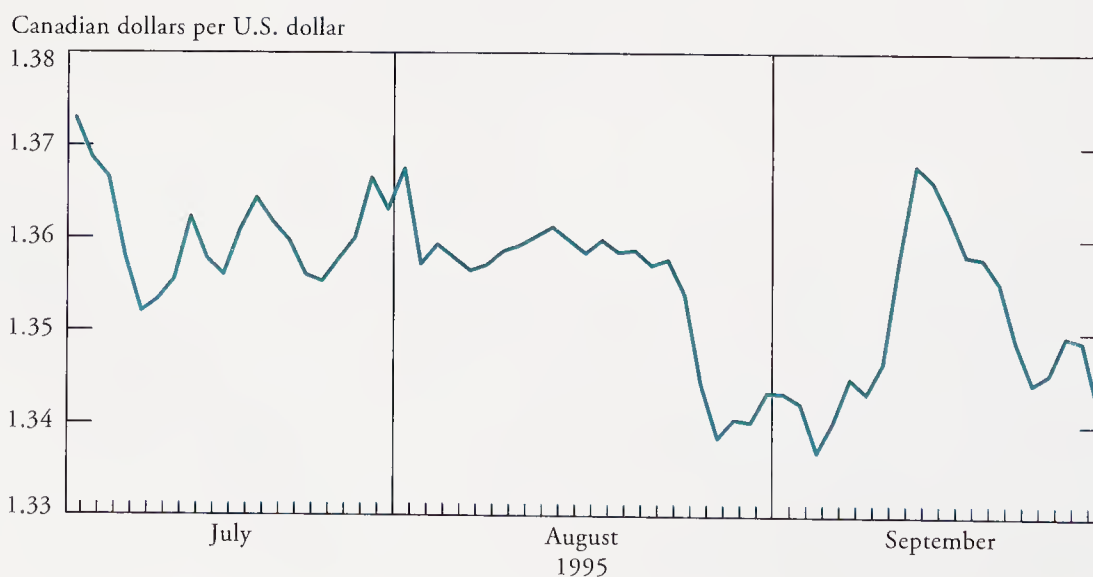
Over the quarter, the Canadian dollar was buffeted by shifting prospects concerning Quebec sovereignty and Quebec's relationship with the rest of Canada. Early in the quarter, the Canadian dollar traded with a firmer tone as several polls showed dwindling support for separation. As the currency firmed, the Bank of Canada lowered short-term interest rates. Specifically, on July 6 immediately following the FOMC's decision, the Bank of Canada reduced its overnight call target range by 25 basis points. In the following weeks, the Bank of Canada lowered interest rates three more times to arrive at the end-of-quarter overnight range of 6.00 to 6.50 percent, 175 basis points below the recent peak in early May.

In late August, the Canadian dollar rallied to a 19-month high of C\$1.3345. In early September, however, the Canadian dollar came under pressure following the official launch of the Quebec referendum campaign. The referendum, set for October 30, proposed

Chart 5

THE DOLLAR AGAINST THE CANADIAN DOLLAR

Spot Exchange Rate



sovereignty in conjunction with economic and political links with the rest of Canada.² Following the release of the official referendum question, the Canadian currency declined almost 2.4 percent as polls indicated growing support for Quebec sovereignty. In the final weeks of the quarter, however, polls began to indicate an improved outlook for a “no” outcome in the referendum. The Canadian dollar recovered much of its losses of the prior weeks and consolidated in a narrower range, ending the quarter at C\$1.3416.

MEXICO

Over the quarter, the peso declined 2.1 percent against the dollar to close at NP6.377, from its second quarter close of NP6.245. At the outset of the quarter, the perception became more widespread that the Mexican authorities were conducting appropriately tight monetary and fiscal policies as inflation and interest rates declined from April highs, that the government would be able to meet heavy tesobono maturities in July and August, and that official transparency was improving.

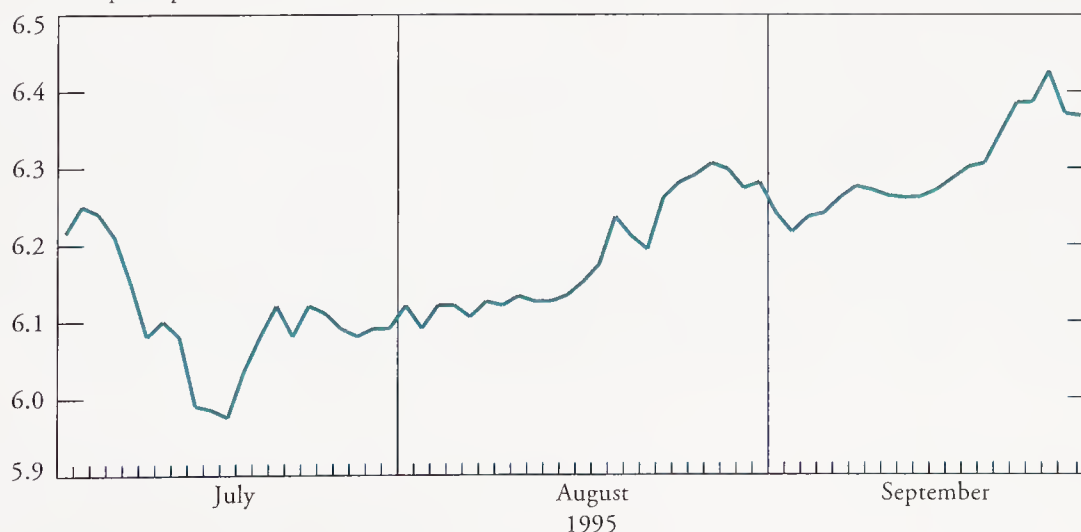
Given these improvements, and against the backdrop of an easing of U.S. interest rates, Mexican markets rallied, and the peso traded to a 1995 high against the dollar of NP5.98. In this environment, Mexico returned to the international capital markets, successfully launch-

Chart 6

THE U.S. DOLLAR AGAINST THE MEXICAN PESO

Spot Exchange Rate

Mexican pesos per U.S. dollar



Source: Federal Reserve Bank of New York.

ing several international bond issues during the period. At the same time, Mexican authorities took steps to reduce the peso's volatility in the context of a floating exchange rate. In particular, the Bank of Mexico encouraged the early redemption of maturing dollar-indexed tesobonos directly through the central bank in order to minimize spikes in dollar demand during a period of heavy tesobono maturities. During the quarter, tesobonos maturing totalled \$7.4 billion, reducing the outstanding balance to \$2.6 billion from \$29.2 billion at the beginning of the year. In addition, dollar borrowings from the central bank's FOBAPROA lending facility were reduced to zero, as local banks continued to find alternative sources of dollar funding.

For most of the quarter, the peso traded in a range of approximately NP6.00 to NP6.30 against the dollar. As concern about default dissipated, many market participants shifted their focus to Mexico's longer-term prospects, cautiously assessing the timing and sources of a return to economic growth and the impact of banking system problems. In the last few weeks of the period, amid several uncertainties on the domestic front, spillover from events elsewhere in Latin America, and usual quarter-end pressures, the peso's decline accelerated slightly to close at NP6.3770.

The Mexican authorities drew \$2.5 billion on July 5 on their medium-term facility with the ESF, bringing the total amount drawn by Mexico under the Medium-Term Stabilization Agreement to \$10.5 billion. In addition, on August 1, the ESF and the Federal Reserve System renewed the Bank of Mexico's short-term swaps, each for \$1 billion, for an additional three months.

TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE RESERVES

The U.S. monetary authorities intervened three times during the period, buying a total of \$1.133 billion against the Japanese yen and \$400 million against the German mark. On all three occasions, intervention operations were divided equally by the Federal Reserve System and the ESF. On July 3 the Treasury issued \$2.5 billion of SDR certificates to Federal Reserve Banks.

At the end of the period, the current values of the foreign exchange reserve holdings of the Federal Reserve System and the ESF were \$21.7 billion and \$29.1 billion, respectively. The U.S. monetary authorities regularly invest their foreign currency balances in a variety of official instruments that yield market-related rates of return and have a high degree of liquidity and credit quality. A significant portion of the balances is invested in foreign government-issued securities. As of September 30, the Federal Reserve and the ESF held, either directly or under repurchase agreement, \$7.7 billion and \$11.2 billion, respectively, in foreign government securities.

ENDNOTES

1. The dollar's movements on a trade-weighted basis against ten major currencies are measured using an index developed by staff at the Board of Governors of the Federal Reserve System.
2. The referendum question itself was introduced in the Quebec National Assembly on September 7, 1995. It reads as follows: "Do you agree that Quebec should become sovereign, after having made a formal offer to Canada for a new economic and political partnership, within the scope of the bill respecting the future of Quebec and the agreement signed on June 12, 1995?"

Table 1

FOREIGN CURRENCY HOLDINGS OF U.S. MONETARY AUTHORITIES BASED ON CURRENT EXCHANGE RATES

Millions of Dollars

		Quarterly Changes in Balances by Source				
	Balances as of June 30, 1995	Net Purchases and Sales ^a	Impact of Sales ^b	Investment Income	Currency Valuation Adjustments ^c	Balances as of September 30, 1995
Federal Reserve						
Deutsche marks	13,936.0	(200.0)	(11.9)	147.7	(442.0)	13,429.8
Japanese yen	8,931.4	(566.7)	(24.8)	33.6	(1,220.7)	7,152.9
Mexican pesos ^d	967.5	(14.1)	0.0	14.1	(11.3) ^e	956.2
Subtotal	23,834.8	(780.8)	(36.7)	195.5	(1,674.0)	21,538.9
Interest receivables ^f	126.0					114.1
Total	23,960.8					21,653.0
U.S. Treasury Exchange Stabilization Fund						
Deutsche marks	7,153.2	(200.0)	(11.9)	77.6	(223.7)	6,795.1
Japanese yen	12,843.9	(566.7)	(24.8)	40.8	(1,784.0)	10,509.3
Mexican pesos ^d	9,000.0	2,485.9	0.0	14.1	0.0 ^e	11,500.0
Subtotal	28,997.1	1,719.2	(36.7)	132.5	(2,007.7)	28,804.5
Interest receivables ^f	72.8					304.0
Total	29,069.9					29,108.5

Note: Figures might not sum because of rounding.

^a Purchases and sales for the purpose of this table include foreign currency sales and purchases related to official activity, swap drawings and repayments, and warehousing.

^b This number is calculated using marked-to-market exchange rates; it represents the difference between the sale exchange rate and the most recent revaluation exchange rate. Realized profits and losses on sales of foreign currencies, computed as the difference between the historic cost-of-acquisition exchange rate and the sale exchange rate, are reflected in Table 2.

^c Foreign currency balances are marked-to-market monthly at month-end exchange rates.

^d See Table 4 for a breakdown of Mexican swap activities. Note that the investment income on Mexican swaps is sold back to Mexico.

^e Valuation adjustments on peso balances do not affect profit and loss because the impact is offset by the unwinding of the forward contract at the repayment date. Note that the ESF does not mark-to-market its peso holdings, but the Federal Reserve System does.

^f Interest receivables for the ESF are revalued at month-end exchange rates. Interest receivables for the Federal Reserve System are carried at cost and are not marked-to-market until interest is paid.

Table 2

**NET PROFITS OR (LOSSES) ON U.S. TREASURY AND
FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS BASED ON
HISTORIC COST-OF-ACQUISITION EXCHANGE RATES**

Millions of Dollars

	Federal Reserve	U.S. Treasury Exchange Stabilization Fund
Valuation profits and losses on outstanding assets and liabilities as of June 30, 1995		
Deutsche marks	3,433.5	1,342.0
Japanese yen	3,454.8	4,966.4
Total	6,888.3	6,308.5
Realized profits and losses from foreign currency sales ^a		
June 30, 1995 - September 30, 1995		
Deutsche marks	39.8	27.4
Japanese yen	192.9	193.0
Total	232.7	220.4
Valuation profits and losses on outstanding assets and liabilities as of September 30, 1995 ^b		
Deutsche marks	2,939.8	1,079.0
Japanese yen	2,016.4	2,964.7
Total	4,956.3	4,043.7

Note: Figures might not sum because of rounding.

^a As indicated in Table 1, foreign currency sales totaled \$400.0 million against German marks and \$1,133.3 million against Japanese yen.

^b Valuation profits or losses are not affected by peso holdings, which are canceled by forward contracts.

Table 3

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

<u>Institution</u>	<u>Amount of Facility</u>	<u>Outstanding as of September 30, 1995</u>
Austrian National Bank	250	0
National Bank of Belgium	1,000	0
Bank of Canada	2,000	0
National Bank of Denmark	250	0
Bank of England	3,000	0
Bank of France	2,000	0
Deutsche Bundesbank	6,000	0
Bank of Italy	3,000	0
Bank of Japan	5,000	0
Bank of Mexico ^a		
Regular swaps	3,000	1,000
Temporary swaps	3,000	0
Netherlands Bank	500	0
Bank of Norway	250	0
Bank of Sweden	300	0
Swiss National Bank	4,000	0
Bank for International Settlements		
Dollars against Swiss francs	600	0
Dollars against other authorized European currencies	1,250	0
Total	35,400	1,000

**U.S. TREASURY EXCHANGE STABILIZATION FUND CURRENCY
ARRANGEMENTS**

Millions of Dollars

<u>Institution</u>	<u>Amount of Facility</u>	<u>Outstanding as of September 30, 1995</u>
Deutsche Bundesbank	1,000	0
Bank of Mexico ^a		
Regular Swaps	3,000	1,000
United Mexican States ^a		
Medium-Term Swaps		10,500
Total ^a		11,500

^a Facilities available to Mexico comprise short-term swaps between the Bank of Mexico and both the Federal Reserve and the ESF, as well as medium-term swaps and government guarantees between the Government of Mexico and the ESF. The total amount available from both medium-term swaps and government guarantees is \$20 billion, less any outstanding drawings on the short-term facilities.

Table 4

**DRAWINGS/ROLLOVERS (+) AND REPAYMENTS (-) BY MEXICAN
MONETARY AUTHORITIES**

Millions of Dollars

	Outstanding as of June 30, 1995	July	August	September	Outstanding as of September 30, 1995
Reciprocal Currency Arrangements with the Federal Reserve					
Bank of Mexico (regular)	1,000.0	0.0	+1,000.0 ^a -1,000.0 ^a	0.0	1,000.0
Currency Arrangements with the U.S. Treasury Exchange Stabilization Fund					
Bank of Mexico (regular)	1,000.0	0.0	+1,000.0 ^a -1,000.0 ^a	0.0	1,000.0
Medium term	8,000.0	+2,500.0	0.0	0.0	10,500.0

Note: Data are on a value-date basis.

^a Drawing of February 2 was renewed on August 1 for an additional three months.

TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS

October–December 1995

During the fourth quarter of 1995, the dollar appreciated modestly, strengthening 3.7 percent against the Japanese yen and 0.5 percent against the German mark. The dollar also rose 0.6 percent on a trade-weighted basis against other G-10 currencies.¹ Toward the end of the quarter, the dollar consolidated in increasingly narrow ranges, and trading activity declined as market participants reduced their risk appetite ahead of year-end. The U.S. monetary authorities did not undertake any intervention operations during the quarter. In other operations, the U.S. Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve System each received repayments from Mexico in the amount of \$350 million on their respective short-term swap arrangements and renewed the same arrangements in the amount of \$650 million each for an additional ninety days.

SUBDUED YEAR-END MARKET ACTIVITY

The dollar opened the quarter at DM 1.4273 and ¥99.55 and proceeded to fluctuate between DM 1.3808 and DM 1.4550 and ¥99.28 and ¥104.12 during the period. In the environment of limited risk-taking witnessed during the quarter, countervailing political and economic developments in the United States and overseas helped to keep the dollar in these relatively narrow ranges. The dollar closed the quarter at DM 1.4339 and ¥103.20.

This report, presented by Peter R. Fisher, Executive Vice President, Federal Reserve Bank of New York, and Manager, System Open Market Account, describes the foreign exchange operations of the U.S. Department of the Treasury and the Federal Reserve System for the period from October 1995 through December 1995. Soo J. Shin was primarily responsible for preparation of the report.

THE DOLLAR GRADUALLY APPRECIATES AGAINST THE YEN

The dollar modestly extended its gains against the yen from the previous quarter as the wide interest rate differential and signs of reduced trade imbalances between the United States and Japan continued to favor the dollar. In addition, the prospects for fiscal consolidation in the United States combined with a better U.S. economic outlook relative to other major economies also helped to support market sentiment for the dollar.

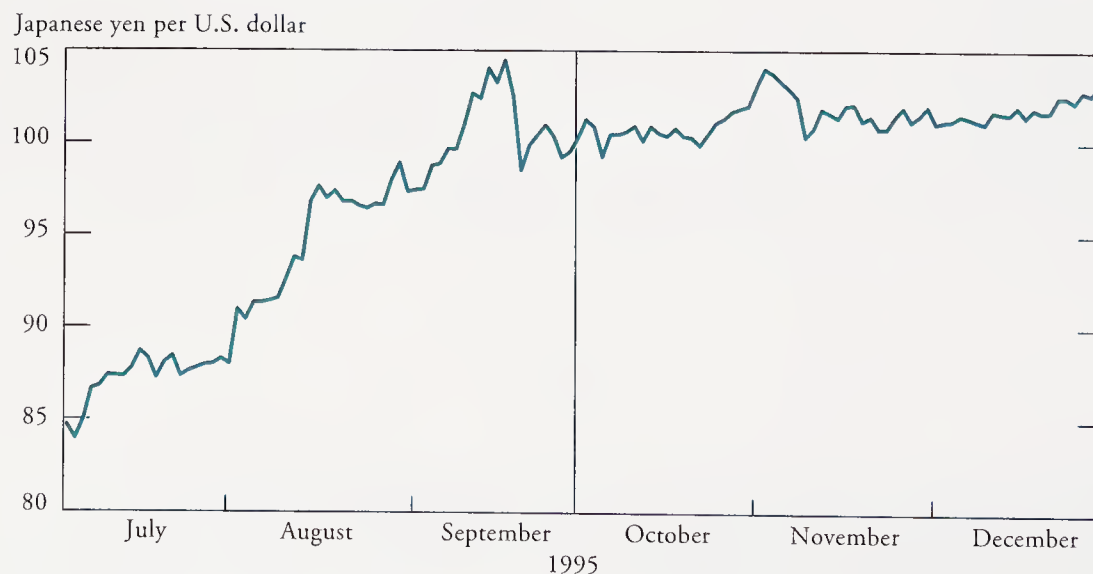
As in the prior quarter, market participants continued to anticipate increased private capital outflows from Japan as a result of low domestic interest rates and sizable domestic debt maturing in the fourth quarter. The substantial decrease in Japan's current account surplus also contributed to the negative sentiment for the yen. Furthermore, most Japanese exporters were perceived to be absent from the marketplace, having already filled their hedging requirements. On the other hand, Japanese institutional investors reportedly purchased dollars in conjunction with acquisitions of U.S. government securities. Amidst these factors, the dollar rose to the quarter's high of ¥104.12 on November 2.

The dollar also benefited in part from market perceptions of a weak Japanese banking system and of a lack of transparency in Japanese banks' accounting practices and nonperforming loan disclosures. After several Japanese banks were downgraded by a credit rating agency, short-term funding costs for nearly all Japanese banks increased sharply, exacerbated by year-end

Chart 1

THE DOLLAR AGAINST THE JAPANESE YEN

Spot Exchange Rate

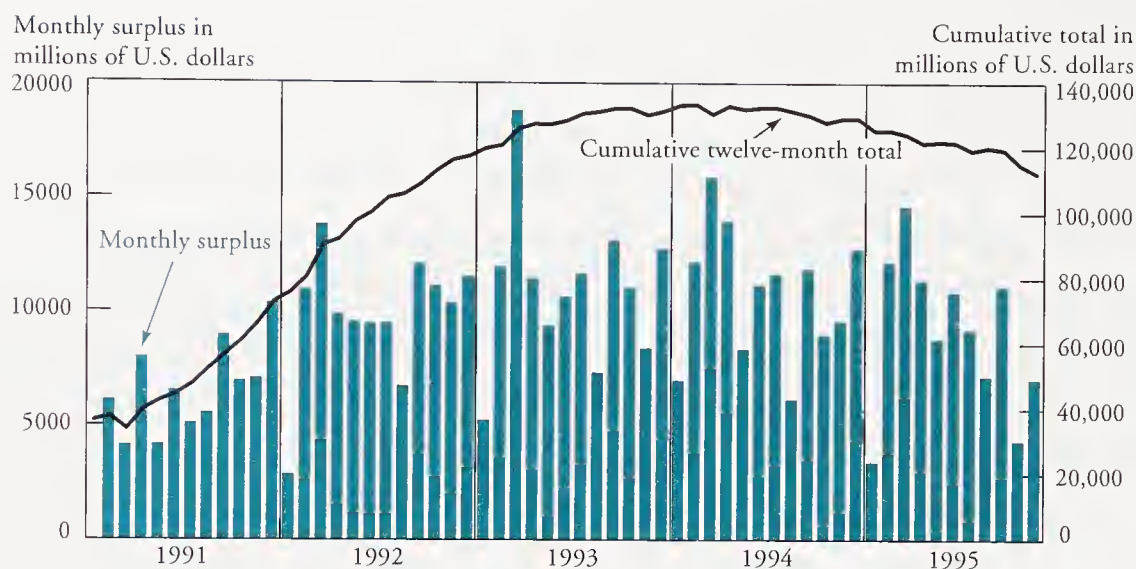


Source: Federal Reserve Bank of New York.

funding pressures. Stress on the Japanese banking system was highlighted by problems related to Daiwa Bank's operations in the United States and the lack of a resolution to the troubled housing loan corporations (*jusen*). These concerns were manifested in additional premia on yen- and dollar-denominated LIBOR deposits that Japanese banks had to pay to borrow money.

Chart 2

JAPANESE CURRENT ACCOUNT BALANCE

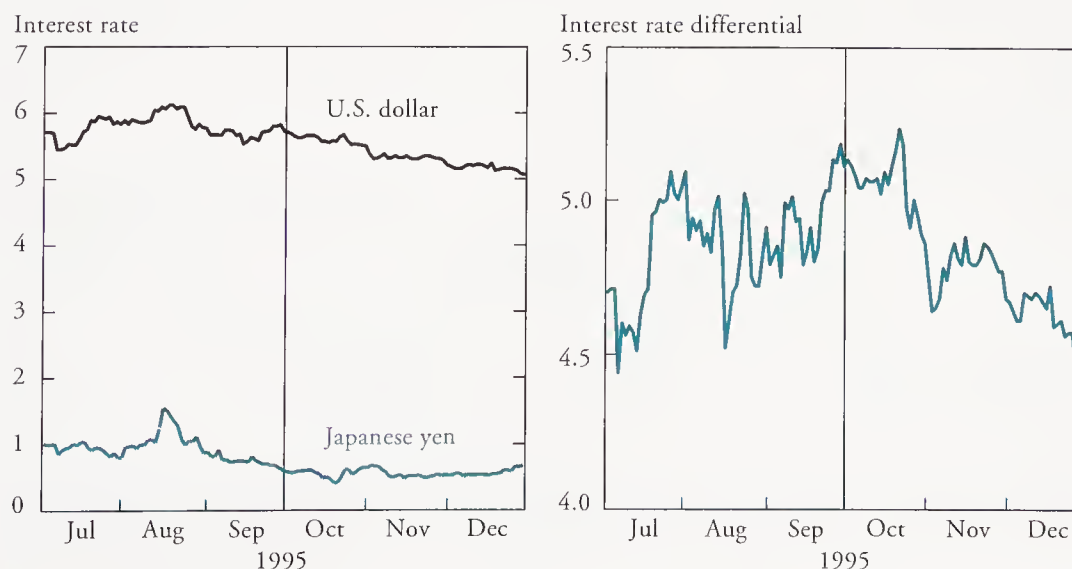


Source: Bloomberg L.P.

Chart 3

DIFFERENTIAL BETWEEN DOLLAR AND JAPANESE YEN SHORT-TERM INTEREST RATES

Implied by the Three-Month Eurodeposit Futures (March 1996 Contracts)



Source: Bloomberg L.P.

Although the “Japan premium” receded subsequently, concerns about the health of the Japanese banking system continued to linger through the remainder of the quarter.

TENSIONS AMONG CURRENCIES IN THE EUROPEAN UNION

As the quarter began, the dollar eased against the mark. Among the factors adversely affecting the dollar, tensions among currencies in the European Union (EU) remained most discernible. These strains sporadically escalated as public-sector strikes against social security reform measures intensified in France and uncertainty regarding the future of Prime Minister Dini’s government in Italy threatened to jeopardize the 1996 budget process. In late October, as these events increasingly drew the attention of market participants, the German mark generally strengthened against other EU currencies. Subsequently, the dollar sustained losses against the mark to reach the quarter’s low of DM 1.3808. Later, however, the French government demonstrated its commitment to preserve the core social security reform measures, and Italy’s 1996 budget process advanced. As a result, the mark reversed its earlier trend and weakened against other European currencies. In turn, this weakening trend helped the dollar to recover against the mark.

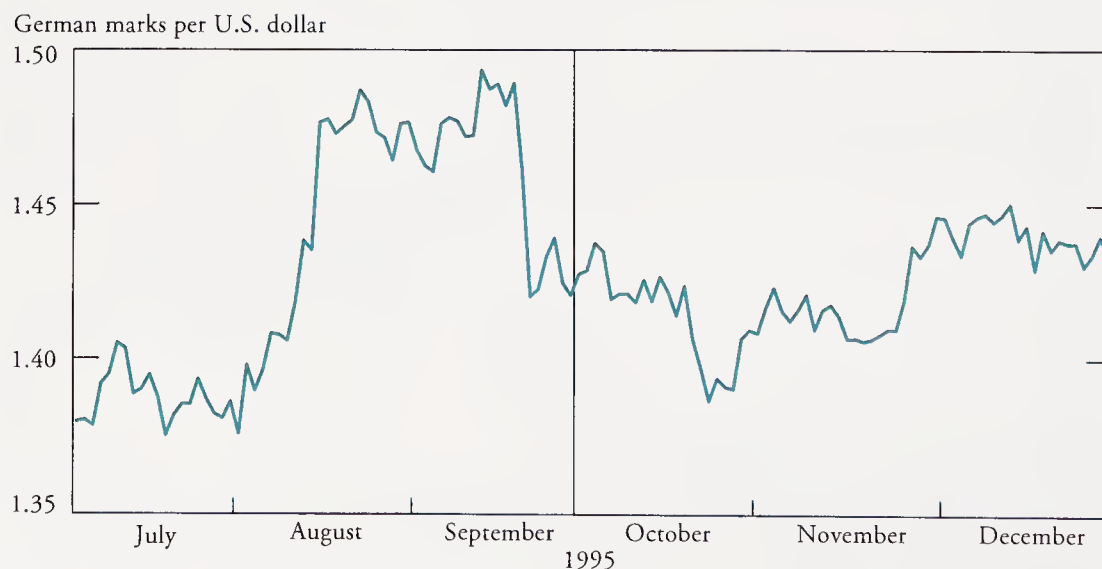
EXPECTATIONS OF LOWER INTEREST RATES IN EUROPE

As the quarter progressed, expectations that European interest rates would decline, bolstered by evidence of slowing economic growth and subsiding inflationary pressures in major European

Chart 4

THE DOLLAR AGAINST THE GERMAN MARK

Spot Exchange Rate



Source: Federal Reserve Bank of New York.

countries, boosted the dollar to the quarter's high of DM 1.4550 against the mark on December 8. Subsequently, central banks in Germany, the United Kingdom, France, and several other European countries lowered their official interest rates by 25 to 50 basis points in December, leading market participants to expect further easing.

The positive effect on the dollar stemming from expectations of lower European interest rates was partly offset by increasing expectations of monetary easing in the United States, where signs of somewhat slower economic growth and subdued inflationary pressures persisted. On December 19, the Federal Reserve reduced the federal funds rate by 25 basis points. Subsequently, expectations of monetary easing in Europe outpaced expectations in the United States and remained a dollar-supportive factor.

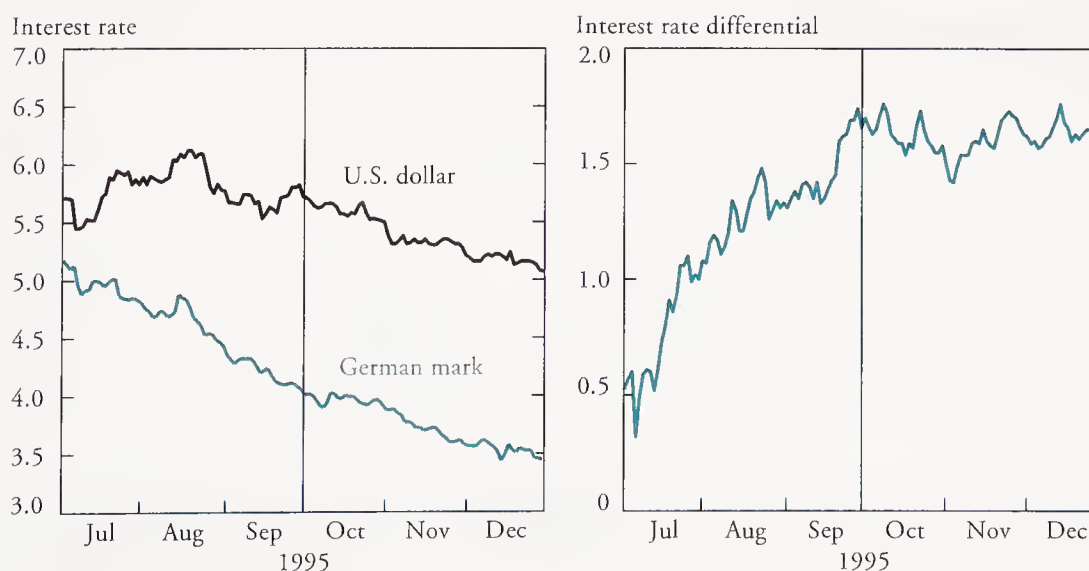
UNCERTAINTIES SURROUNDING THE U.S. BUDGET NEGOTIATIONS

Throughout the quarter, the apparent consensus on achieving a balanced budget in the United States was viewed by market participants as a positive development for the U.S. asset markets. At times, however, particularly toward the end of the quarter, concerns about the ceiling on the U.S. Treasury's borrowing authority somewhat impeded the dollar's gains. In the U.S. government securities market, the protracted impasse in budget negotiations raised concerns

Chart 5

DIFFERENTIAL BETWEEN DOLLAR AND GERMAN MARK SHORT-TERM INTEREST RATES

Implied by the Three-Month Eurodeposit Futures (March 1996 Contracts)



Source: Bloomberg L.P.

about possible disruptions in the regular Treasury auction schedule and contractions in the supply of Treasury securities. Because foreign exchange market participants generally did not take significant dollar positions based on the potential outcome of the budget negotiations, however, the net effect of these concerns on the dollar was muted.

NORTH AMERICAN DEVELOPMENTS

In Canada, financial markets were volatile preceding the referendum on Quebec independence. In the third week of October, the Canadian dollar fell to a four-month low of CAD 1.3790 against the U.S. dollar as opinion polls indicated an even split between “yes” and “no” votes. After the secessionist referendum was defeated the Canadian dollar recovered, but given the narrow margin of defeat focus turned immediately to the possibility of another referendum in the near future.

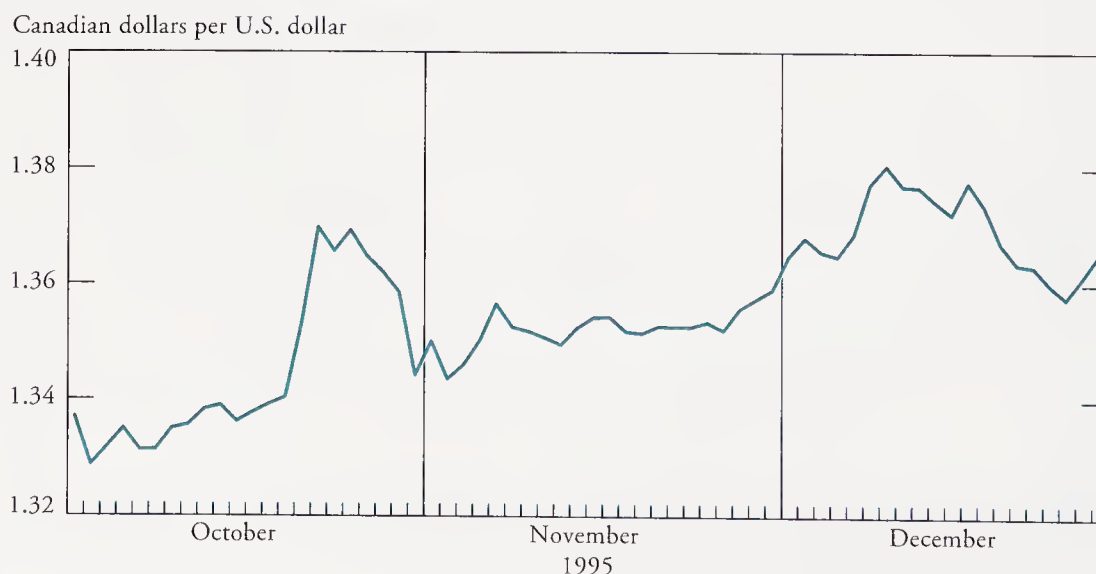
Following the referendum, market participants increasingly anticipated monetary easing by the Bank of Canada, and the Canadian dollar resumed its weakening trend against the U.S. dollar. On December 20, the Bank of Canada lowered its overnight call rate by 25 basis points following the Federal Reserve’s policy easing. The Canadian dollar traded calmly for the remainder of the month.

In Mexico, financial markets encountered abrupt selling pressures in the first half of the quarter as political concerns and worse than expected economic data rekindled doubts about the

Chart 6

THE DOLLAR AGAINST THE CANADIAN DOLLAR

Spot Exchange Rate



Source: Federal Reserve Bank of New York.

timing of and prospects for economic recovery. The ensuing sell-off was exacerbated by the reluctance among many investors to hold Mexican assets toward year-end. Near the end of the quarter, the Mexican monetary authorities tightened liquidity conditions and purchased pesos in the foreign exchange market to dampen volatility. The Mexican financial markets stabilized, and the peso, at NP 7.70, closed the quarter 17.2 percent weaker against the dollar.

MEXICAN SWAP ACTIVITY

On October 11, Mexico made partial repayment on its short-term swap arrangements with the U.S. monetary authorities. A total of \$700 million was repaid, divided evenly between the Federal Reserve System and the ESF. Subsequently, the respective short-term arrangements, with principal amounts totalling \$1.3 billion, were renewed on October 30 for ninety days.

TREASURY AND FEDERAL RESERVE FOREIGN EXCHANGE RESERVES

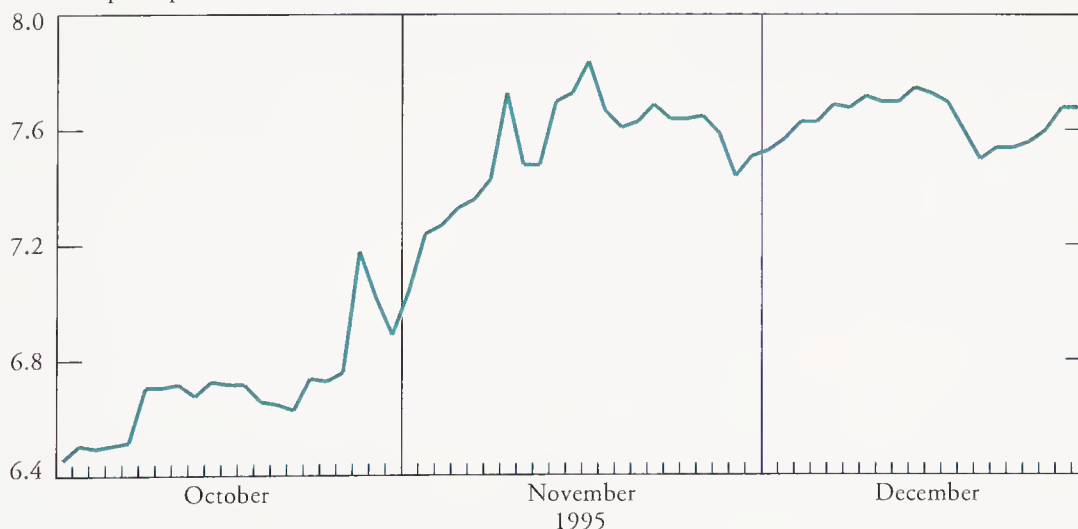
The U.S. monetary authorities did not undertake any intervention operations this quarter. At the end of the quarter, the current values of the German mark and Japanese yen reserve holdings of the Federal Reserve System and the ESF were \$20.5 billion and \$17.0 billion, respectively. The U.S. monetary authorities invest all of their foreign currency balances in a variety of official instruments that yield market-related rates of return and have a high degree of liquidity and credit quality. A significant portion of these holdings are invested in German and Japanese

Chart 7

THE U.S. DOLLAR AGAINST THE MEXICAN PESO

Spot Exchange Rate

Mexican pesos per U.S. dollar



Source: Federal Reserve Bank of New York.

government-issued securities. As of December 31 the Federal Reserve and the ESF held \$7.3 billion and \$10.9 billion, respectively, in German and Japanese government securities, either directly or under repurchase agreement.² In addition, the ESF held \$10.5 billion equivalent in nonmarketable Mexican government securities in connection with the medium-term swap arrangement.

ENDNOTES

1. The dollar's movements on a trade-weighted basis against ten major currencies are measured using an index developed by staff at the Board of Governors of the Federal Reserve System.
2. This sentence is corrected and revised from the original text of the "Treasury and Federal Reserve Foreign Exchange Operations" report released February 7, 1996.

Table 1

FOREIGN CURRENCY HOLDINGS OF U.S. MONETARY AUTHORITIES BASED ON CURRENT EXCHANGE RATES

Millions of Dollars

		Quarterly Changes in Balances by Source				
	Balances as of September 30, 1995	Net Purchases and Sales ^a	Impact of Sales ^b	Investment Income	Currency Valuation Adjustments ^c	Balances as of December 31, 1995
Federal Reserve						
Deutsche marks	13,429.8	0.0	0.0	132.6	(47.8)	13,514.7
Japanese yen	7,152.9	0.0	0.0	9.3	(289.8)	6,872.4
Mexican pesos ^d	956.2	(362.4)	0.0	12.4	(4.3) ^e	601.9
Subtotal	21,538.9	(362.4)	0.0	154.4	(341.9)	20,988.9
Interest receivables ^f	114.1					113.5
Other cash flow from investments ^g						(3.3)
Total	21,653.0					21,099.1
U.S. Treasury Exchange Stabilization Fund						
Deutsche marks	6,795.1	0.0	0.0	67.5	(24.2)	6,838.4
Japanese yen	10,509.3	0.0	0.0	4.4	(425.6)	10,088.1
Mexican pesos ^d	11,500.0	(608.9)	0.0	258.9	0.0 ^e	11,150.0
Subtotal	28,804.5	(608.9)	0.0	330.8	(449.8)	28,076.5
Interest receivables ^f	304.0					302.6
Other cash flow from investments ^g						(12.7)
Total	29,108.5					28,366.4

Note: Figures might not sum because of rounding.

^a Purchases and sales for the purpose of this table include foreign currency sales and purchases related to official activity, swap drawings and repayments, and warehousing.

^b This number is calculated using marked-to-market exchange rates; it represents the difference between the sale exchange rate and the most recent revaluation exchange rate. Realized profits and losses on sales of foreign currencies, computed as the difference between the historic cost-of-acquisition exchange rate and the sale exchange rate, are reflected in Table 2.

^c Foreign currency balances are marked-to-market monthly at month-end exchange rates.

^d See Table 4 for a breakdown of Mexican swap activities. Note that the investment income on Mexican swaps is sold back to Mexico.

^e Valuation adjustments on peso balances do not affect profit and loss because the impact is offset by the unwinding of the forward contract at the repayment date. Note that the ESF does not mark-to-market its peso holdings, but the Federal Reserve System does.

^f Interest receivables for the ESF are revalued at month-end exchange rates. Interest receivables for the Federal Reserve System are carried at cost and are not marked-to-market until interest is paid.

^g Cash flow differences from payment and collection of funds between quarters.

Table 2

**NET PROFITS OR (LOSSES) ON U.S. TREASURY AND
FEDERAL RESERVE FOREIGN EXCHANGE OPERATIONS BASED ON
HISTORIC COST-OF-ACQUISITION EXCHANGE RATES**

Millions of Dollars

	Federal Reserve	U.S. Treasury Exchange Stabilization Fund
Valuation profits and losses on outstanding assets and liabilities as of September 30, 1995		
Deutsche marks	2,939.8	1,079.0
Japanese yen	2,016.4	2,964.7
Total	4,956.3	4,043.7
Realized profits and losses from foreign currency sales		
September 30, 1995—December 31, 1995		
Deutsche marks	0.0	0.0
Japanese yen	0.0	0.0
Total	0.0	0.0
Valuation profits and losses on outstanding assets and liabilities as of December 31, 1995 ^a		
Deutsche marks	2,892.0	1,054.8
Japanese yen	1,726.6	2,539.2
Total	4,618.6	3,593.9

Note: Figures might not sum because of rounding.

^a Valuation profits or losses are not affected by peso holdings, which are canceled by forward contracts.

Table 3

FEDERAL RESERVE RECIPROCAL CURRENCY ARRANGEMENTS

Millions of Dollars

<u>Institution</u>	<u>Amount of Facility</u>	<u>Outstanding as of December 31, 1995</u>
Austrian National Bank	250	0
National Bank of Belgium	1,000	0
Bank of Canada	2,000	0
National Bank of Denmark	250	0
Bank of England	3,000	0
Bank of France	2,000	0
Deutsche Bundesbank	6,000	0
Bank of Italy	3,000	0
Bank of Japan	5,000	0
Bank of Mexico ^a		
Regular swaps	3,000	650
Temporary swaps	3,000	0
Netherlands Bank	500	0
Bank of Norway	250	0
Bank of Sweden	300	0
Swiss National Bank	4,000	0
Bank for International Settlements		
Dollars against Swiss francs	600	0
Dollars against other authorized European currencies	1,250	0
Total	35,400	650

**U.S. TREASURY EXCHANGE STABILIZATION FUND CURRENCY
ARRANGEMENTS**

Millions of Dollars

<u>Institution</u>	<u>Amount of Facility</u>	<u>Outstanding as of December 31, 1995</u>
Deutsche Bundesbank	1,000	0
Bank of Mexico ^a		
Regular Swaps	3,000	650
United Mexican States ^a		
Medium-Term Swaps		10,500
Total ^a		11,150

^a Facilities available to Mexico comprise short-term swaps between the Bank of Mexico and both the Federal Reserve and the ESF, as well as medium-term swaps and government guarantees between the Government of Mexico and the ESF. The total amount available from both medium-term swaps and government guarantees is \$20 billion, less any outstanding drawings on the short-term facilities.

Table 4

**DRAWINGS/ROLLOVERS (+) AND REPAYMENTS (-) BY MEXICAN
MONETARY AUTHORITIES**

Millions of Dollars

	Outstanding as of September 30, 1995	October	November	December	Outstanding as of December 31, 1995
Reciprocal Currency Arrangements with the Federal Reserve					
Bank of Mexico (regular)	1,000.0	-350.0 -650.0 ^a +650.0 ^a	0.0	0.0	650.0
Currency Arrangements with the U.S. Treasury Exchange Stabilization Fund					
Bank of Mexico (regular)	1,000.0	-350.0 -650.0 ^a +650.0 ^a	0.0	0.0	650.0
(medium term)	10,500.0	0.0	0.0	0.0	10,500.0

Note: Data are on a value-date basis.

^a Remainder of February 2 drawing was renewed on October 30 for an additional ninety days.

REPORT FROM THE PRESIDENT

REPORT FROM THE PRESIDENT

COMMITMENT

At the Federal Reserve Bank of New York we are committed to maintaining the highest standards of integrity and excellence. We are also committed to pursuing our central banking missions to further the public interest through a supportive relationship with our employees. These missions include implementing monetary and foreign exchange policies and providing basic research and analysis to support policy formulation and implementation, promoting the safety and soundness of the domestic and international financial system, providing high-quality, cost-effective payment and other banking services and participating, with our constituencies, in issues related to the Second District's economic vibrancy.

During 1995, we made significant contributions to key policy initiatives, met a number of demanding management challenges, and made several major organizational changes in the Bank's internal structure to position the Bank for even stronger performance. It is our intention to place the Bank more firmly in the forefront of developing and carrying out the public policy agenda associated with the central bank's missions and to continue our commitment to innovative leadership.

FOCUS

In recent years, we have focused on strengthening the Bank's automation, information-gathering and analytical capabilities. This has advanced the Bank's leadership role in shaping the Federal Reserve's monetary and supervisory policies and in meeting the banking service needs of the Treasury, depository institutions, and foreign central banks. We have undertaken parallel efforts to increase the productivity of staff, reduce support and overhead costs, and strengthen operating efficiency throughout the Bank by flattening supervisory and management structures and by reengineering a broad range of work processes and reporting relationships.

The results of this focus can be seen in the Bank's considerable accomplishments in 1995, which included:

- playing a key role in the United States' provision of liquidity support to Mexico by assisting in the negotiations between the United States and Mexico, implementing the swap agreement between the two countries and providing market intelligence to policymakers;
- developing and implementing public policy on the management of payments system risk and sponsoring best practice standards for participants in the over-the-counter market;
- introducing more efficient trading techniques in our management of the Federal Reserve System's domestic portfolio;
- developing a central bank strategy for dealing with foreign exchange settlement risk under the auspices of the G-10 Central Bank Governors' Committee on Payment and Settlement Systems;
- developing new market-risk standards for banks under the auspices of the G-10 Committee on Banking Supervision;
- establishing the Federal Reserve's guidelines for the analysis and valuation of complex financial instruments pledged by banks as discount-window collateral;
- facilitating agreement among the bank supervisory agencies to replace regulatory accounting principles with generally accepted accounting principles (GAAP) for financial statements;
- shaping public policy on regional economic and urban issues by holding a major regional conference on technology and economic development in the tri-state area and advancing community development initiatives aimed at improving export financing opportunities for small businesses and mortgage credit availability for low- and moderate-income households; and
- advancing strategic automation initiatives that strengthened the Bank's operating efficiency while furthering the Federal Reserve System's automation consolidation goals.

The Bank's success—whether measured in terms of the economy's performance or the attainment of Federal Reserve System or Bank objectives—depends on a team-oriented culture dedicated to public policy goals. A key focus of the Bank is on developing and retaining a broad base of professional, technical and managerial staff by instituting progressive programs that position the Bank as an employer of choice in the New York financial community.

In 1995, the Bank made a number of changes in its overall compensation and career development programs to advance this position. We introduced flexible work arrangements in selected areas, thoroughly revamped our career development program and established an in-house career resource center at our Head Office.

BUILDING INTERNAL STRENGTHS

We continued to adapt and reengineer our own work processes and organizational structures in 1995 to better position the Bank to advance our missions in today's rapidly changing financial environment.

In our Bank Supervision area, a reorganization begun in 1994 was completed, with this area of the Bank moving to a flatter organizational structure with greater responsibility and accountability for each member of Bank Supervision's management team. The reorganization was aimed at improving overall efficiency and maximizing career development opportunities and job enrichment for our staff. In the Markets area of the Bank, efficiency gains and synergies are being realized through a major reorganization that integrated the responsibilities and activities of Open Market, Foreign Exchange and Market Surveillance staffs.

The need to focus the Bank's efforts in a systematic way on financial developments in newly industrial and emerging economies led the Bank to establish a new Emerging Markets and International Affairs Group in December 1995.

The prior year's reorganization of the Research and Market Analysis Group bore fruit in 1995 in the form of a more effective management structure. Working within that structure, the Bank was able to significantly enhance the quality and quantity of its research work, expand its external publications and enhance the Bank's research reputation.

ENVIRONMENTAL OUTLOOK

Continuing changes in the domestic and international financial system will present the Bank with formidable challenges. We need to gain a broader understanding of the workings of the newly

emerging markets in Asia and Latin America and the effects that developments in these markets have on U.S. monetary and bank supervisory policies. It is clear to us that the susceptibility of these markets, as well as our own domestic markets, to periodic disruptions will require the Bank to continue its supervisory vigilance and to maintain a strong crisis management capability. The Bank's experience with Daiwa Bank also is being assessed with a view toward enhancing the way we, and other bank supervisory agencies, supervise the branches and agencies of foreign banks operating in the United States.

The merger of Chemical and Chase in 1996, which will form the largest banking organization in the United States, and the implementation of the revised Community Reinvestment Act regulation, initially will necessitate some increase in our examiner resources. However, interstate branch banking, which will go into full effect under Federal law in 1997, may have some offsetting effects on our bank supervision resources. At the same time, consolidations and strong competition from bank and non-bank service providers could well generate volume declines across the Bank's entire range of financial services.

Within the Bank, the composition of our staff will continue to shift toward policy-oriented professional positions and analytical-technical senior staff positions. At the same time, a variety of automation technologies and automated capabilities will become increasingly integrated into our internal operating environment. To address these staff composition and environmental changes, we intend to continue our investments in state-of-the-art computers and software and our multi-year modernization of the Bank's physical infrastructure.

MANAGEMENT CHALLENGES FOR 1996

Operational improvement strategies will be particularly important in the provision of financial services by the Bank. The past year was marked by a major effort on the part of financial services management to develop and begin implementing aggressive, comprehensive, multi-year strategies aimed at substantially improving unit cost performance in all of the Bank's financial services during the 1996-1998 period. Implementing a three-year plan for the Check Function will be especially challenging. An initial aspect of that plan, closing the Jericho Office by October 1996 and consolidating Jericho processing at EROC and check adjustments at Utica, was announced earlier in 1996.

FINANCIAL HIGHLIGHTS

The Federal Reserve Bank of New York's financial performance in 1995 demonstrates another aspect of our commitment—to fiscal responsibility and to maintaining the highest standards of integrity in our operations.

- The Bank's total operating expense was \$628 million, an increase of 2.1 percent over 1994.
- Our financial services achieved full-cost recovery in 1995. Book-entry securities service exceeded target, while funds transfer and ACH services fell slightly short of their cost recovery targets. Check processing significantly improved its year-over-year cost recovery but did not meet its target primarily due to larger-than-anticipated volume declines.
- Our net earnings available for distribution during the year were \$9.5 billion. Of this amount, \$61 million was paid to member banks as statutory dividends on their Reserve Bank stock, \$69 million was transferred to the Bank's surplus account and \$9.4 billion was paid to the U.S. Treasury.
- At year-end 1995, our total assets stood at \$183.9 billion, up from \$169.0 billion at year-end 1994.

FINANCIAL STATEMENTS

FEDERAL RESERVE BANK OF NEW YORK

STATEMENT OF CONDITION

In Dollars

Assets	December 31, 1995	December 31, 1994
Gold Certificates	4,273,059,792	4,133,635,217
Special Drawing Rights Certificates	3,903,000,000	2,808,000,000
Coin	19,509,815	18,697,679
Items in Process of Collection	763,668,763	648,912,240
U.S. Government and Federal Agency Securities, Net	166,400,947,234	146,780,936,411
Investments Denominated in Foreign Currencies	5,654,172,110	6,267,086,655
Accrued Interest Receivable	1,760,726,294	1,514,553,208
Property & Equipment, Net	226,593,820	221,028,182
Other Assets	891,021,117	734,096,200
Interdistrict Settlement Account	—	5,852,633,645
Total Assets	183,892,698,945	168,979,579,437
Liabilities and Capital		
Liabilities		
Federal Reserve Notes Outstanding, Net	139,004,388,019	151,607,516,466
Deposits:		
Depository Institutions	8,657,672,258	7,105,402,568
U.S. Treasury, General Account	5,979,192,840	7,161,094,854
Other Deposits	426,213,829	281,225,181
Deferred Credit Items	733,999,354	550,535,468
Interest on Federal Reserve Notes Due U.S. Treasury	289,458,974	131,183,807
Accrued Benefit Cost	128,603,205	110,051,829
Other Liabilities	42,552,860	57,303,764
Interdistrict Settlement Account	26,517,386,306	—
Total Liabilities	181,779,467,645	167,004,313,937
Capital		
Capital Paid-in	1,056,615,650	987,632,750
Surplus	1,056,615,650	987,632,750
Total Capital	2,113,231,300	1,975,265,500
Total Liabilities and Capital	183,892,698,945	168,979,579,437

The accompanying notes are an integral part of these financial statements.

FEDERAL RESERVE BANK OF NEW YORK

STATEMENT OF INCOME

In Dollars

	December 31, 1995	December 31, 1994
Interest Income		
Interest on U.S. Government Securities	9,387,450,289	6,942,877,055
Interest on Foreign Currencies	211,055,484	255,017,462
Interest on Loans to Depository Institutions	1,579,408	605,303
Total Interest Income	9,600,085,181	7,198,499,820
Other Operating Income		
Income from Services	96,356,576	101,971,655
Reimbursable Services to Government Agencies	47,916,037	43,915,081
Foreign Currency Gains/(Losses)	269,388,856	689,957,173
Government Securities Gains/(Losses)	2,973,126	(9,095,296)
Other Income	27,260,794	139,709,773
Total Operating Income	443,895,389	966,458,386
Operating Expense		
Salaries and Other Benefits	262,326,496	251,954,633
Occupancy Expense	38,136,227	36,720,003
Equipment Expense	36,830,599	38,114,109
Cost of Unreimbursed Treasury Services	3,416,012	3,234,295
Assessments by Board of Governors	190,289,603	185,938,579
Other Expense	97,310,185	99,926,418
Total Operating Expense	628,309,122	615,888,037
Income Before Cumulative Effect of Accounting Change	9,415,671,448	7,549,070,169
Cumulative Effect of Change in Accounting Principle	(15,585,891)	—
Net Income Before Net Periodic Pension Expense	9,400,085,557	7,549,070,169
Net Periodic Pension Expense	(119,217,028)	(75,646,845)
Net Income	9,519,302,585	7,624,717,014
Distribution of Net Income		
Dividends paid to Member Banks	61,464,192	58,789,295
Transferred to Surplus	68,982,900	18,988,250
Payments to U.S. Treasury	9,388,855,493	7,546,939,469
Total Distribution	9,519,302,585	7,624,717,014

The accompanying notes are an integral part of these financial statements.

FEDERAL RESERVE BANK OF NEW YORK
STATEMENT OF CHANGES IN CAPITAL

In Dollars

	Capital Stock	Surplus	Total Equity
Balance at December 31, 1994 (19,752,655 million shares)	987,632,750	987,632,750	1,975,265,500
Net Income Transferred to Surplus		68,982,900	68,982,900
Net Capital Stock			
Issued/(Redeemed) (1,379,658 million shares)	68,982,900		68,982,900
Balance at December 31, 1995 (21,132,313 million shares)	1,056,615,650	1,056,615,650	2,113,231,300

The accompanying notes are an integral part of these financial statements.

NOTES TO FINANCIAL STATEMENTS

1. ORGANIZATION

The Federal Reserve Bank of New York (the Bank) is part of the Federal Reserve System created by Congress under the Federal Reserve Act of 1913 which established the central bank of the United States. The Federal Reserve System (System) consists of the Board of Governors of the Federal Reserve (Board of Governors) and twelve Federal Reserve Banks (Reserve Banks). The Reserve Banks are federal instrumentalities chartered by the federal government and possess a unique set of governmental, corporate and central bank characteristics. Other major elements of the System are the Federal Open Market Committee and the Federal Advisory Council. The Reserve Banks are not subject to federal or state income taxes.

Corporate Structure

The Bank and its branch in Buffalo, New York serve the Second Federal Reserve District that includes the state of New York, the ten northern counties of New Jersey and Fairfield County Connecticut, as well as the Commonwealth of Puerto Rico and the U.S. Virgin Islands. In accordance with the Federal Reserve Act, the Bank has a corporate structure with supervision and control exercised by a Board of Directors chosen partly by nomination and election by member banks and partly by the Board of Governors. Banks that are members of the System include all national banks and any state-chartered bank that elects to become a member.

Board of Directors

The Federal Reserve Act specifies the composition of district boards of directors. Each board is comprised of nine members serving three-year terms: three directors, including those designated as Chairman and Deputy Chairman, are appointed by the Board of Governors and six directors are elected by member banks. Of the six elected by member banks, three represent the public and three represent member banks. Member banks are divided into three classes according to size. Member banks in each class elect one director representing member banks and one representing the public. In any election of directors, a member bank's one vote is not affected by the number of shares of the Reserve Bank stock it holds.

2. OPERATIONS AND SERVICES

The Bank and other Reserve Banks and the Board of Governors perform a variety of services and operations. Functions include: formulating and conducting monetary policy; participating actively in the payments mechanism, including large-dollar transfers of funds, automated clearing house operations and check processing; distribution of coin and currency; fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the federal government's bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies and state member banks on behalf of the Board of Governors; and administering regulations of the Board of Governors. The Board of Governors' operating costs are funded through assessments on the Reserve Banks.

3. SIGNIFICANT ACCOUNTING POLICIES

In carrying out its responsibilities as part of the nation's central bank, the Bank participates in activities that result in income for the Bank, particularly interest income from securities held in the System Open Market Account. The income is incidental to the Federal Reserve's public responsibilities and does not motivate its activities or policy decisions. Specialized accounting principles for entities with the unique powers and responsibilities of the nation's central bank have not been formulated by the Financial Accounting Standards Board. The Board of Governors of the System has developed specialized accounting principles and practices which it believes are appropriate for the significantly different nature and function of a central bank as compared to the private sector. These accounting principles and practices are generally documented in the "Financial Accounting Manual" which is maintained by the Board of Governors of the System. All Reserve Banks are required to adopt and apply accounting policies and practices which are consistent with the Financial Accounting Manual. Accounting and disclosures for U.S. government and federal agency securities and investments denominated in foreign currencies (as further described in notes 3(d), 4 and 5) are consistent with the Financial Accounting Manual. The Bank has elected not to include a Statement of Cash Flows as the liquidity and cash position of the Bank are not of primary concern to users of these financial statements. Other information regarding the Bank's activities is provided in, or may be derived from, the Statements of Condition, Income and Changes in Capital. Therefore, a Statement of Cash Flows would not provide any additional useful information. There are no other significant differences between the policies outlined in the Financial Accounting Manual and generally accepted accounting principles. Unique accounts and significant accounting policies are explained below.

a. Gold Certificates

The Secretary of the Treasury is authorized to issue gold certificates to the Reserve Banks to monetize gold held by the U.S. Treasury. Payment for the gold certificates by the Reserve Banks is made by crediting equivalent amounts in dollars into the account established for the U.S. Treasury. These gold certificates held by the Reserve Banks are required to be backed by the gold of the U.S. Treasury. The U.S. Treasury may retire the gold certificates at any time and the Reserve Banks must deliver them to the U.S. Treasury. At such time, the U.S. Treasury's account is charged and the Reserve Banks' gold certificate account is lowered. The value of gold for purposes of backing the gold certificates is set by the Federal Reserve Act at \$42.2222 a fine troy ounce. The Board of Governors reallocates the gold certificates among Reserve Banks once a year based upon Federal Reserve notes outstanding in each district.

b. Special Drawing Rights Certificates

Special drawing rights are issued by the International Monetary Fund to its members according to the capital each country deposits with the Fund upon membership. The special drawing rights serve as a supplement to international monetary reserves and may be transferred, somewhat like gold, from one national monetary authority to another. Under the law providing for United States participation in the special drawing rights system, the Secretary of the U.S. Treasury is authorized to transfer special drawing rights certificates by crediting equivalent amounts in dollars into the account established for the U.S. Treasury. The Reserve Banks are required to purchase them for the purpose of financing special drawing rights certificate acquisitions or for financing exchange stabilization operations. Upon changes in the amount of monetized special drawing rights, Reserve Bank holdings of special drawing rights certificates are adjusted proportionate to their respective totals of Federal Reserve notes outstanding at the end of the preceding year.

c. Loans to Depository Institutions

The Depository Institutions Deregulation and Monetary Control Act of 1980 provides that all depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in Regulation D issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Banks. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Loans are evaluated for collectibility and currently all are considered collectible and fully collateralized. If any loans were deemed to be uncollectible, an appropriate reserve would be established. Interest is recorded on the accrual method and is charged at the discount rate established at least every fourteen days by the Board of Directors of the Bank, subject to review by the Board of Governors. However, Reserve Banks retain the option to impose a surcharge above that rate in certain circumstances.

d. U.S. Government and Federal Agency Securities and Investments Denominated in Foreign Currencies

The Federal Open Market Committee (FOMC) is composed of the Board of Governors, the Bank's president and, on a rotating basis, four other Reserve Bank presidents. The FOMC designated the Bank to execute open market transactions. The FOMC establishes policy regarding the open market operations, oversees these operations, and issues authorizations and directives to the Bank for its execution of transactions for the System Open Market Account (SOMA), which is participated or designated to each Reserve Bank. Authorized transaction types include direct purchases and sales of securities and matched sale-purchase transactions. The Bank is also authorized to buy securities under agreements for repurchase that are not participated or designated to each Reserve Bank. These transactions are conducted in government and federal agency securities. The securities are held in the SOMA at the Bank.

Specifically, the Federal Reserve provides or absorbs additional reserve deposits of depository institutions by purchasing or selling government securities, respectively, in the open market. While the application of current market prices to the securities currently held by the Reserve Banks may result in values substantially above or below their carrying values, these unrealized changes in value would have no necessary effect on the quantity of reserves available to the banking system or on the prospects for future Reserve Bank earnings or capital.

In addition to conducting outright purchases and sales of securities, the Bank is authorized by the FOMC to enter into matched sale-purchase transactions. These are generally overnight transactions in which the Bank sells a security and buys it back the next day at the rate specified at the commencement of the transaction. These transactions are accounted for as separate sale and purchase transactions. At December 31, 1995, the Bank had matched sale-purchase transactions involving U.S. Government securities with a par value of \$12.3 billion.

In addition to operations in the domestic securities market, the Bank is authorized by the FOMC to execute operations in foreign exchange markets for major currencies and to invest those currencies to the extent possible in investments with maturities of less than 12 months. Balances and changes in balances arise from transactions for the purpose of countering disorderly conditions in exchange markets and other needs specified by the FOMC in carrying out its central bank responsibilities.

Each Federal Reserve Bank participates in the above activities that result in income for the Bank. Although the resulting portfolio generates interest income and the transactions can result in gains or losses when holdings are sold prior to maturity, decisions regarding the securities and foreign

currencies, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, earnings and any gains or losses resulting from the sale of such currencies and securities are incidental to the open market operations and do not motivate its activities or policy decisions.

In order to ensure the effective conduct of open-market operations, the FOMC authorizes select Reserve Banks to lend U.S. Government securities held in SOMA to U.S. Government securities dealers and to banks participating in Government securities clearing arrangements conducted through a Reserve Bank, under such instructions as the FOMC may specify from time to time. At December 31, 1995, U.S. Government securities with a par value of \$1.1 billion were loaned. These securities-lending transactions are fully collateralized by other U.S. Government securities. Accordingly, these transactions are off balance sheet and, therefore, are not reflected in the accompanying financial statements. It is the Reserve Banks' policy to take possession of the collateral in amounts in excess of the market values of the securities loaned. The market values of the collateral and the securities loaned are monitored by the Reserve Banks on a daily basis, with additional collateral obtained as necessary.

U.S. securities comprising the SOMA are recorded at cost, on a settlement-date basis, adjusted for the amortization of premiums and accretion of discounts on a straight-line basis. Interest income is recorded on the accrual method. Gains and losses resulting from sales of securities are determined by the specific identification method.

e. Bank Premises and Equipment

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from 2 to 50 years. New assets, major alterations, renovations and improvements are capitalized at cost as additions to the asset accounts. Maintenance, repairs and minor replacements are charged to operations in the year incurred.

f. Other Real Estate (ORE)

ORE is comprised of commercial real estate properties held for sale or future use in operations. ORE assets are carried at the lower of cost or fair value. Subsequent write-downs that may be required to the carrying value of these assets and losses realized from asset sales are charged to operating expense. Gains realized from the sale of ORE are included in other operating income.

g. Interdistrict Settlement Account

At the close of business each day, all Reserve Banks and branches assemble the payments due to or from other Reserve Banks and branches as a result of transactions involving accounts residing in other Districts that occurred during the day's operations. Such transactions may include check and ACH clearing operations. The cumulative net amount due to or due from other Reserve Banks is reported as the interdistrict settlement account.

h. Federal Reserve Notes

Federal Reserve notes, the circulating currency of the nation, are issued through the various Federal Reserve agents to the Reserve Banks upon deposit with such agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be equal to the sum of the notes applied for by such Reserve Bank. Due to the stability and short-term nature of the securities tendered, the collateral value is equal to the par value of such securities. The Board of Governors may at any time call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy its obligation to provide sufficient collateral for its outstanding Federal Reserve notes, the Bank is a party to an agreement with the eleven other Reserve Banks which provides that certain assets of the Reserve Banks are jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks. At December 31, 1995, the Bank's total holdings of securities were pledged as collateral. In the event that this collateral is insufficient, the Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Bank. Finally, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the United States government.

i. Capital Paid-in

The Federal Reserve Act requires that each member bank subscribe to the capital stock of its Reserve Bank in an amount equal to 6 percent of the capital and surplus of the member bank. Member banks are those state-chartered banks that choose to join the System and all national banks. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. These shares, with a par value of \$100, may not be transferred or hypothecated. As a member bank's capital and surplus changes, its holdings of the Reserve Bank's stock must be adjusted.

By law, each member bank is entitled to receive an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

j. **Surplus**

The amount of surplus, as designated by the Board of Governors, is intended to provide additional capital and reduce the possibility that the Bank would be required to call on member banks for additional capital. After providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in, excess earnings have historically been transferred to the U.S. Treasury (generally as payment of interest on Federal Reserve notes outstanding). In the event of losses, payments to the U.S. Treasury are suspended until such losses are recovered through subsequent earnings. Weekly payments to the U.S. Treasury vary significantly.

k. **Accounting Change**

Effective January 1, 1995, the Financial Accounting Manual was changed to require the Bank to use the accrual method of accounting to recognize the obligation to provide benefits to former or inactive employees, consistent with the requirements of Statement of Financial Accounting Standards ("SFAS") No. 112, "Employers' Accounting for Postemployment Benefits". Prior to 1995, the Bank recognized costs for postemployment benefits when paid. The cumulative effect of this change in accounting for benefits was recognized by the Bank as a one-time charge to expense of \$11.7 million. Additionally, the Bank recognized an increase in 1995 operating expenses of approximately \$1.2 million as a result of the change in accounting for these costs.

Effective January 1, 1995, the Bank also began accruing a liability for employees' rights to receive compensation for future absences consistent with SFAS No. 43, "Accounting for Compensated Absences". Prior to 1995, the Bank recognized these costs when paid. The cumulative effect of this change in accounting for compensated absences was recognized by the Bank as a one-time charge to expense of \$3.9 million. Ongoing operating expenses for the year ended December 31, 1995, were not materially impacted by the change in accounting for these costs.

4. U.S. GOVERNMENT AND FEDERAL AGENCY SECURITIES

Securities are held in the SOMA at the Bank. An undivided interest in the SOMA is designated to each Reserve Bank on a percentage basis derived from an annual settlement, performed in April of each year, of interdistrict clearings and equalization among the Reserve Banks of gold certificate holdings to Federal Reserve notes outstanding. Gains and losses on sales of these securities are allocated to each Reserve Bank based on that Bank's designated share of the total portfolio. The Bank's allocated share of securities held in SOMA at December 31, 1995 was approximately 39.75 percent.

Securities held in the System Open Market Account and the Bank's allocated share at December 31, 1995 were as follows (in thousands):

	Total SOMA Account	Allocated to Bank
Par Value:		
Federal Agency	\$ 2,633,995	\$ 1,046,893
U.S. Treasury:		
Bills	183,115,712	72,780,143
Notes	151,013,150	60,020,839
Bonds	<u>44,068,604</u>	<u>17,515,259</u>
Total Par	380,831,461	151,363,134
Unamortized Premiums	4,508,183	1,791,797
Unaccreted Discounts	<u>(3,477,093)</u>	<u>(1,381,986)</u>
	\$381,862,551	\$151,772,945

In addition to the above balances, the Bank holds securities under repurchase agreement. These balances are not allocated to other Reserve Banks. Securities held under repurchase agreement at December 31, 1995 were as follows (in thousands):

Par Value:	
Federal Agency	\$ 1,100,000
U.S. Treasury	<u>12,762,000</u>
Total Par	13,862,000
Unamortized Premiums	902,643
Unaccreted Discounts	<u>(136,641)</u>
	\$14,628,002

The maturities of investment securities in the SOMA account at December 31, 1995 were as follows (in thousands):

Maturities of Securities Held	Par Value	
	U.S. Government Securities	Federal Agency Obligations
Within 15 days	\$ 7,580,018	\$ 240,000
16 days to 90 days	93,738,368	474,000
91 days to 1 year	123,216,569	527,295
Over 1 year to 5 years	85,272,558	840,950
Over 5 years to 10 years	31,469,096	526,750
Over 10 years	<u>36,920,857</u>	<u>25,000</u>
Total	\$378,197,466	\$2,633,995

The maturities of investment securities allocated to the Bank at December 31, 1995 were as follows (in thousands):

Maturities of Securities Held	Par Value	
	U.S. Government Securities	Federal Agency Obligations
Within 15 days	\$ 3,012,711	\$ 95,389
16 days to 90 days	37,256,725	188,393
91 days to 1 year	48,972,966	209,576
Over 1 year to 5 years	33,891,952	334,239
Over 5 years to 10 years	12,507,530	209,359
Over 10 years	<u>14,674,357</u>	<u>9,937</u>
Total	\$150,316,241	\$1,046,893

5. INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

The Bank, on behalf of the Reserve Banks, maintains accounts with foreign central banks and The Bank for International Settlements and holds foreign currency deposits and government debt instruments denominated in foreign currencies. Each Reserve Bank is allocated a share of foreign currency-denominated assets based upon the ratio of its capital and surplus to aggregate capital and surplus at the preceding December 31. Gains and losses are allocated to each Reserve Bank based on that bank's designated share of the total portfolio.

Investments denominated in foreign currencies are limited to maturities of less than one year and are accounted for at cost on a settlement-date basis, adjusted for amortization of premiums and accretion of discounts using a method that approximates the effective interest rate method. Foreign currency-denominated assets of the Reserve Banks are revalued monthly at current market exchange rates in order to report these assets in U.S. dollars. Interest income is recorded on the accrual basis. These investments are guaranteed as to principal and interest by the foreign governments or are contracts with the central banks or The Bank for International Settlements.

During 1995, the Federal Reserve Bank of New York was authorized to hold balances of and to have outstanding forward contracts to receive or to deliver the following foreign currencies:

Australian schillings	Italian lire
Belgian francs	Japanese yen
Canadian dollars	Mexican pesos
Danish kroner	Netherlands guilders
Pounds sterling	Norwegian kroner
French francs	Swedish kroner
German marks	Swiss francs

In addition, at the direction of the FOMC, the Bank is authorized to maintain reciprocal currency arrangements ("F/X swaps") for SOMA for periods up to a maximum of 12 months with the following foreign central banks:

Foreign Central Bank	Amount of Arrangement (Millions of Dollars Equivalent)
Austrian Nation Bank	250
National Bank of Belgium	1000
Bank of Canada	2000
National Bank of Denmark	250
Bank of England	3000
Bank of France	2000
Deutsche Bundesbank	6000
Bank of Italy	3000
Bank of Japan	5000
Bank of Mexico	6000 *
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	4000
Bank for International Settlements:	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1250

* The swap arrangement with the Bank of Mexico consists of a regular \$3 billion line and a special temporary \$3 billion line. The special line expired on January 31, 1996. As of December 31, 1995, \$650 million was outstanding on this facility; however, this amount was repaid in January 1996 and as of March 31, 1996, there was no amount outstanding on this facility.

In connection with its foreign currency activities, the Bank, on behalf of the Reserve Banks, enters into contracts that may involve off-balance sheet market risk and credit risk because they may represent contractual commitments involving future settlement. The credit risk is controlled through credit approvals, limits and monitoring procedures.

Foreign exchange contracts are contractual agreements between two parties to exchange a specified currency, at a specified price, on a specified date. Spot foreign contracts normally settle two days after the trade date, whereas the settlement date on forward contracts is negotiated between the contracting parties, but will extend beyond two days from the trade date up to one year. The Bank generally enters into spot contracts, with any forward contracts generally limited to the second leg of a swap/warehousing transaction. Swaps are executed only with authorized foreign central banks, while warehousing transactions are authorized only with the U.S. Treasury and the Exchange Stabilization Fund. As of December 31, 1995, the Reserve Banks had no open foreign exchange contracts.

An F/X swap arrangement is a renewable, short-term reciprocal currency arrangement between two parties, the Bank, on behalf of the Reserve Banks, and an authorized foreign central bank, who mutually agree to exchange their currencies up to a prearranged maximum amount and for an agreed upon period of time, generally for one year. These arrangements give the Federal Reserve temporary access to the foreign currencies which it needs for intervention operations, and give the partner foreign central bank temporary access to dollars they need to support their own currencies. As of December 31, 1995, there was a \$650 million open F/X swap contract, with the Bank of Mexico.

The FOMC has an agreement to “warehouse” foreign currencies for the U.S. Treasury and the Exchange Stabilization Fund (ESF). This is an arrangement under which the FOMC agrees to exchange, at the request of the Treasury, U.S. dollars for foreign currencies held by the Treasury or ESF over a limited period of time. The purpose of the warehousing facility is to supplement the U.S. dollar resources of the Treasury and ESF for financing purchases of foreign currencies and related international operations. As of December 31, 1995, this facility was \$20 billion, with no open agreements.

6. BANK PREMISES AND EQUIPMENT

A summary of bank premises and equipment at December 31, 1995 is as follows (in thousands):

Bank Premises:	
Land	\$ 21,218
Buildings	102,403
Building machinery and equipment	50,043
Construction in progress	<u>12,491</u>
	186,155
Less accumulated depreciation	<u>39,667</u>
Bank Premises, net	146,488
Furniture and equipment	211,776
Less accumulated depreciation	<u>131,670</u>
Furniture and equipment, net	\$ 80,106

Depreciation expense for the year ended December 31, 1995 was \$28.8 million.

7. COMMITMENTS

At December 31, 1995, the Bank was obligated under noncancelable leases for premises and equipment with terms, including renewal options, ranging from one to approximately eight years, which provide for increased rentals based upon increases in real estate taxes, operating costs or selected price indices.

Rental expense under capital and operating leases for certain operating facilities, warehouses, data processing, and office equipment (including taxes, insurance and maintenance when included in rent and contingent rentals), net of sublease rentals, was \$16.8 million in 1995. Certain of the Bank's leases have options to renew, and there are no significant contingent rentals.

Future minimum rental payments under capital leases and noncancellable operating leases, net of sublease rentals with terms of one year or more, at December 31, 1995, were (in thousands):

	Operating	Capital
1996	\$11,020	\$3,297
1997	887 *	3,165
1998	10,426	912
1999	10,425	0
2000	10,425	0
Thereafter	<u>19,489</u>	<u>0</u>
	\$62,672	\$7,374

Accumulated amortization of capital leases was \$5.4 million at December 31, 1995.

* Payment of \$9,565,000 fixed minimum rent for 1997 for 59 Maiden Lane space occupied by the Bank was made at the time of lease renewal in 1988.

8. RETIREMENT AND THRIFT PLANS

Substantially all of the Reserve Banks' employees participate in the Retirement Plan for Employees of the System. The System's plan is a defined benefit plan which covers employees of the Reserve Banks, the Board of Governors and the Plan Administrative office. Benefits are based on length of service and level of compensation. The Bank acts as the Plan sponsor, including the net periodic pension expense on its balance sheet. The net periodic pension expense includes amounts related to Board of Governors participation in the Plan.

Salary and salary-related expenses of the Office of Employee Benefits, the Plan Administrator, are paid for by the Plan. The Office of Employee Benefits is a related party to the Reserve Bank. In 1994, the most recent date for which data are presently available, the amounts of such expenses paid by the Plan which were estimated to be attributable to the administration of the Thrift Plan, Long Term Disability Income Plan and Supplemental Survivor Income Plan for Employees of the Federal Reserve System aggregated to approximately \$2,025,000.

For the year ended December 31, 1994, investment service fees of approximately \$7,490,000 and administrative expenses of approximately \$1,457,000, which include charges of \$1,200,000 from certain related parties within the Federal Reserve System primarily for rent, systems support, personnel, postage and data processing, on a specific allocation basis, were paid by the Retirement Plan.

Contributions to the System's plan are actuarially determined and fully funded by participating employers at amounts prescribed by the Plan Administrator. No separate accounting is maintained of assets contributed by the participating employers, and net pension expense for the period is the required contribution for the period. As of December 31, 1994, the most recent date for which data are presently available, actuarial calculations showed that the fair market value of the assets of the System's plan exceeded the projected benefit obligations. Based on these calculations, it was determined that employer funding contributions were not required and the excess plan assets will continue to fund future years' contributions.

Following is a summary of the components of the net periodic pension expense that is recognized on the Bank's Statement of Income for the year ending December 31, 1995 (in millions).

Service cost—benefits earned during the period	\$ 49
Interest cost on projected benefit obligation	133
Expected return on assets	(257)
Amortization of initial net asset at January 1, 1987	(45)
Amortization of prior service cost	6
Amortization of net gain	(9)
Net periodic pension expense	(123)
Cost of special termination benefits	4
Net periodic pension expense after special termination benefits	\$(119)

Employees of the Bank may also participate in the Federal Reserve System's Thrift Plan. Under the Thrift Plan, employees may contribute a percentage of their salaries up to a maximum 19 percent limit as prescribed by the Internal Revenue Service. Matching contributions by the Bank are based on a fixed percentage of each employee's basic contribution. Currently, the Bank matches 80 percent of the employees' contributions up to 6 percent of their salary. The Bank's Thrift Plan contributions totaled \$8.1 million in 1995.

9. POSTRETIREMENT BENEFITS OTHER THAN PENSIONS

In addition to the Bank's defined benefit retirement plan, employees who have met certain age and length of service requirements are eligible for both medical benefits and life insurance coverage during retirement. The retiree medical plan is contributory and provides benefits to retirees, their covered dependents and beneficiaries. The life insurance plan is noncontributory and covers retirees only.

The Bank funds benefits payable under the medical and life insurance plans as due, using a January 1 measurement date. The following is a reconciliation between the plan's funded status and the amounts recognized in the Bank's balance sheet as of December 31, 1995 (in millions).

Accumulated postretirement benefit obligation:	
Retirees and covered spouses	\$ 55
Actives eligible to retire	16
Other actives and disables	40
Total accumulated postretirement benefit obligation	111
Unamortized net transition obligation	0
Unrecognized net gain (loss)	(1)
Unrecognized prior service cost	1
Accrued postretirement benefit cost	\$111

Costs for the Bank were projected using an 8.75 percent discount rate and the following health care cost trend rates. The initial trend rate for medical costs for 1995 is 11 percent, with the ultimate trend rate of 6.5 percent by 2004.

The following is a summary of the components of net periodic postretirement cost for the year ended December 31, 1995 (in millions).

Service Costs	\$ 3
Interest costs of accumulated benefit obligation	9
Net amortization and deferral	<u>0</u>
Net periodic cost	\$12

The Bank began using the accrual method of accounting to recognize the obligation to provide benefits to former or inactive employees, consistent with SFAS No. 112 "Employers Accounting for Postemployment Benefits," effective January 1, 1995. Benefits include medical and dental insurance, survivor income and disability benefits. Costs were projected using the same discount rate and the same health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit cost recognized by the Bank at December 31, 1995, was \$12.9 million. Net periodic costs of \$3.3 million were included in 1995 operating expenses.

10. CONTINGENCIES

The Bank is involved in certain legal actions and claims arising in the ordinary course of business. Although it is difficult to predict the ultimate outcome of these actions, in management's opinion, based on discussions with counsel, the aforementioned litigation and claims will be resolved without material adverse effect on the financial position of the Bank.

DIRECTORS OF THE
FEDERAL RESERVE BANK OF NEW YORK

DIRECTORS OF THE FEDERAL RESERVE BANK OF NEW YORK

<i>Directors</i>	<i>Term expires Dec. 31</i>	<i>Class</i>
ROBERT G. WILMERS Chairman, President, and Chief Executive Officer Manufacturers and Traders Trust Company, Buffalo, N.Y.	1995	A
J. WILLIAM JOHNSON Chairman and Chief Executive Officer The First National Bank of Long Island, Glen Head, N.Y.	1996	A
J. CARTER BACOT Chairman and Chief Executive Officer The Bank of New York, New York, N.Y.	1997	A
WILLIAM C. STEERE, JR. Chairman and Chief Executive Officer Pfizer Inc., New York, N.Y.	1995	B
SANDRA FELDMAN President, United Federation of Teachers, New York, N.Y.	1996	B
EUGENE R. McGRATH Chairman, President and Chief Executive Officer Consolidated Edison Company of New York, Inc., New York, N.Y.	1997	B
HERBERT L. WASHINGTON Owner, HLW Fast Track, Inc., Rochester, N.Y.	1995	C
JOHN C. WHITEHEAD, <i>Deputy Chairman</i> Chairman, AEA Investors Inc., New York, N.Y.	1996	C
MAURICE R. GREENBERG, <i>Chairman and Federal Reserve Agent</i> Chairman and Chief Executive Officer American International Group, Inc., New York, N.Y.	1997	C

Directors-Buffalo Branch

GEORGE W. HAMLIN IV President and Chief Executive Officer The Canandaigua National Bank and Trust Company, Canandaigua, N.Y.	1995
F.C. RICHARDSON President, Buffalo State College, Buffalo, N.Y.	1995
JOSEPH J. CASTIGLIA, <i>Chairman</i> Vice Chairman, President and Chief Executive Officer Pratt & Lambert United, Inc., Buffalo, N.Y.	1996

Directors-Buffalo Branch (Continued)

Term expires Dec. 31

LOUISE C. WOERNER Chairman and Chief Executive Officer HCR, Rochester, N.Y.	1996
MARK W. ADAMS Operator, Adams Poultry Farm, Naples, N.Y.	1997
DONALD L. RUST Plant Manager, Tonawanda Engine Plant, GM Powertrain Division General Motors Corporation, Buffalo, N.Y.	1997
WILLIAM E. SWAN President and Chief Executive Officer Lockport Savings Bank, Lockport, N.Y.	1997

CHANGES IN DIRECTORS—1996

Member banks in this District reelected ROBERT G. WILMERS a class A director of this Bank for a three-year term beginning January 1996. Mr. Wilmers, who is Chairman, President and Chief Executive Officer of Manufacturers and Traders Trust Company, Buffalo, N.Y., had been serving as a class A director since January 1993.

Member banks in this District also reelected WILLIAM C. STEERE, JR. a class B director of this Bank for a three-year term beginning January 1996. Mr. Steere, who is Chairman and Chief Executive Officer of Pfizer Inc., New York, N.Y., had been serving as a class B director since January 1993.

The Board of Governors of the Federal Reserve System designated JOHN C. WHITEHEAD as Chairman of the Board and Federal Reserve Agent for the year 1996. Mr. Whitehead, who is Chairman of AEA Investors Inc., New York, N.Y., has been serving as a class C director and as Deputy Chairman since September 1995. (David A. Hamburg, President, Carnegie Corporation, New York, N.Y., resigned as a class C director and as Deputy Chairman in September.) As Chairman and Federal Reserve Agent, Mr. Whitehead succeeds Maurice R. Greenberg, Chairman of American International Group, Inc., New York, N.Y., who resigned from this Bank's board.

The Board of Governors appointed THOMAS W. JONES a class C director of this Bank for the unexpired portion of Mr. Greenberg's term (ending December 31, 1997), and as Deputy Chairman for the year 1996. Mr. Jones is Vice Chairman, President and Chief Operating Officer of Teachers Insurance and Annuity Association—College Retirement Equities Fund, New York, N.Y.

The Board of Governors also appointed PETER G. PETERSON a class C director of this Bank for a three-year term beginning January 1996. Mr. Peterson is Chairman of the Blackstone Group, New York, N.Y. As a class C director, he succeeds Herbert L. Washington, Owner, HLW Fast Track, Inc., Rochester, N.Y., who served as a class C director since June 1993; prior to that, Mr. Washington had been a director on the Buffalo Branch board since June 1990, serving as its Chairman from January 1992 to June 1993.

Buffalo Branch

The Board of Governors appointed BAL DIXIT a director of the Buffalo Branch for a three-year term beginning January 1996. Mr. Dixit, who is President and Chief Executive Officer of Newtex Industries, Inc., Victor, N.Y., succeeds F.C. Richardson, President of Buffalo State College, who had served as a Buffalo Branch director since August 1993.

The Board of Governors also appointed LOUIS J. THOMAS a director of the Buffalo Branch for the unexpired portion of a term ending December 31, 1997. Mr. Thomas, who is Director, District 4, United Steelworkers of America, Buffalo, N.Y., succeeds Donald L. Rust, Plant Manager, Tonawanda Engine Plant, GM Powertrain Division, General Motors Corporation, Buffalo, N.Y., who resigned from the Branch board.

The Board of Directors of this Bank reappointed GEORGE W. HAMLIN IV a director of the Buffalo Branch for a three-year term beginning January 1996. Mr. Hamlin, who is President and Chief Executive Officer, The Canandaigua National Bank and Trust Company, Canandaigua, N.Y., has been a Branch director since January 1993.

The Board of this Bank redesignated JOSEPH J. CASTIGLIA as Chairman of the Board of the Buffalo Branch for the year 1996. Mr. Castiglia, formerly Vice Chairman, President and Chief Executive Officer of Pratt & Lambert United, Inc., Buffalo, N.Y., has been a director of the Buffalo Branch since January 1991 and has served as Chairman of the Branch board since June 1993.

ADVISORY GROUPS

ADVISORY GROUPS

Federal Advisory Council

Second District Member and Alternate Member

WALTER V. SHIPLEY, *Member*

Chairman

Chemical Banking Corporation, New York, N.Y.

EDWARD D. MILLER, *Alternate Member*

President

Chemical Banking Corporation, New York, N.Y.

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First National Bank of Chicago

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BEN S. BERNANKE

Princeton University

MICKEY LEVY

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Harvard University

ROBERT J. SHILLER

Yale University

BENJAMIN M. FRIEDMAN

Harvard University

WILLIAM L. SILBER

New York University

GLENN HUBBARD

Columbia University

Advisory Council on Small Business and Agriculture

BAL DIXIT, *Chairman*

President and Chief Executive Officer

Newtex Industries, Inc., Victor, N.Y.

JAMES I. NIXON

President and Chief Executive Officer

InLine Brake Manufacturing Corp., Clifton, N.J.

FREDERICK D. CLAUSER

President, Koh-I-Noor Inc., Bloomsbury, N.J.

LORI NORTHRUP

President, Stride Tool, Inc., Ellicottville, N.Y.

PETER D. HANKS

Big Green Farms, Salem, N.Y.

BARBARA B. ROBERTS

President, FPG International, New York, N.Y.

JOHN W. LINCOLN

President, Linholm Farm, Bloomfield, N.Y.

MARTIN SILVER

President and Chief Executive Officer

Northeast Wood Crafts Inc., Amsterdam, N.Y.

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President and Chief Executive Officer
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Basle, Switzerland

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Chicago, Illinois

MATHIS CABIALLAVETTA
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Union Bank of Switzerland
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Dresdner Bank Aktiengesellschaft
Frankfurt, Germany

DR. ULRICH CARTELLIERI
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Senior Executive Vice President
Corporate Banking
Royal Bank of Canada
Toronto, Canada

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Director and Group Chief Financial Officer
NatWest Group
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ING. RICARDO GUAJARDO TOUCHE
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Amsterdam, The Netherlands

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Henry Kaufman and Company, Inc.
New York, N.Y.

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Daiwa Securities Co., Ltd.
Tokyo, Japan

YOH KUROSAWA
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The Industrial Bank of Japan, Ltd.
Tokyo, Japan

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Tokyo, Japan

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Albany, N.Y.

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Perth Amboy, N.J.

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New York, N.Y.

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Floral Park, N.Y.

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President and Chief Executive Officer
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Lockport, N.Y.

CHARLES M. WHITNEY
President and Chief Executive Officer
Empire Corporate Federal Credit Union
Albany, N.Y.

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FELICIA WIGGIN, Cash Officer,
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^a On special assignment to the Office of the First Vice President.

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^b On leave of absence.

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GARY S. WEINTRAUB, Branch Officer

Banking Services; Community Affairs; Facilities; Protection

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HEAD OFFICE (NYC)

Buffalo

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EROC

Queens

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 HEAD OFFICE TERRITORY

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